

5. Case 53-44 - Section XV, 15-204.2(aa) - Training and Educational Costs. A report from the Editing Subcommittee, dated 15 August 1956, presenting an edited version of the subject material was approved by the Committee with the following minor modifications:

15-204.2(aa) (2) (v) was revised to delete (A) and (B). The semicolon appearing after (A) was changed to a comma and the word "and" was added at the end of the paragraph. With these modifications the paragraph was redesignated as (iv) and the existing paragraph (iv) as paragraph (v), deleting the word "and" at the end thereof.

The members were advised that immediately following ASFR approval coordination of the paragraph would be undertaken by the Staff by memorandum with the ASD (M&P).

The subject of industry coordination was discussed, with the Committee recommending that industry be afforded an opportunity to comment, inasmuch as the paragraph covering Training and Educational Costs was marked "Reserved" in the draft of Section XV which was forwarded to industry. Notwithstanding this recommendation, the Committee concurred that formal solicitation of industry comments on this paragraph was a matter for decision by the Staff. AUG 29 1956

11. Case 53-44 - Revision of Part 2, Section XV. The OSD member reported that the Materiel Secretaries have recommended the allowance of costs for help-wanted advertising and advertising in technical publications and that this, plus any remaining problems, is being resolved by higher echelons. A further report will be made by 6 Mar 57.

6 Feb 57

3. Case 53-44 - Revision of Section XV, Part 2. It was noted that this problem is being considered at higher echelons and that a further report will be made on 5 Jun 57.

APR 28 1957

Case 53-44 - Revision of Section XV, Part 2. The members concurred in the request of the Staff for an extension of the reporting date to 3 Jul 57.

(5 Jun 57)

Case 53-44 - Revision of Section XV, Part 2. A report on the status of the revision of Section XV, Part 2, was deferred to the 17 Jul 57 meeting.

(10 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that action on this case had been suspended pending the outcome of the effort on the single set of cost principles. Copies of the letter of transmittal accompanying the single set, from the Secretary of Defense to the three Departments, were distributed to the members only. A further report will be given at the 14 Aug 57 meeting.

(17 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that further action on Part 2, Section XV, is not contemplated, as a result of current efforts to publish the comprehensive set of cost principles. The Army Legal member suggested that in view of this information the case be closed. The members concurred in this suggestion and, accordingly, the case is closed.

(14 Aug 57)

3. Case 53-44 Section XV - 15-204.2(bb) - Training and Educational Expenses. The Committee considered a report from the Special Subcommittee, dated 21 August 1956, covering the subject paragraph on training and educational expenses. After considerable discussion the Subcommittee report was modified as quoted below:

"15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs of salaries or wages of trainees during regular working hours are allowable.

b. The costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes during working hours not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours.

c. The costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education on a full-time basis at a post-graduate (but not under-graduate) college level related to the job requirements of bona fide employees for a total period not to exceed one school year, are allowable. In unusual cases where required by military technology, the period may be extended.

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent set forth in (k) above, (e) above and (t) above, respectively.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered as contributions and will be treated as provided under ASPR 15-204.3(c)."

The report was referred to the Editing Subcommittee with the request that an edited version be presented for consideration by 21 August 1956. In the interim the ASPR members will clear the proposed paragraph within their respective Departments and the Staff will undertake coordination with the Assistant Secretary of Defense (Manpower and Personnel). The Committee further determined that if the paragraph was cleared in time, it would be inserted in Section XV for issuance concurrently with the printing of that section. The Chairman further advised the members that the proposed paragraph probably would be presented to the Procurement and Production Industry Advisory Committee to secure an industrial reaction.

In conjunction with the above paragraph, the subject of the allowability of management and executive training costs was discussed and deferred without action to modify the above paragraph.

In approving the above paragraph the Committee considered and rejected the concept of allowing full-time salaries for bona fide employees on a full-time basis at post-graduate college levels.



9. Case 53-44 - Revision of Section XV - Part 2 - Paragraph 15-204.2(n) - Overtime. The Navy legal member called the Committee's attention to a discrepancy existing in the present revision of Section XV in paragraph 15-204.2(n) with respect to overtime, extra-pay shift and multi-shift premiums. To correct this situation the Committee approved the substitution of the words "otherwise approved" for the words "otherwise authorized" appearing in the fourth line of the paragraph. The Committee further approved the deletion of the words "without prior approval" in next to the last line of the paragraph. AUG 7 1956

3. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Navy legal member called the Committee's attention to a further change required in the subject paragraph in view of the changes approved at the 8/7/56 meeting in paragraph 15-204.2(n) to remove an inconsistency between the two paragraphs. To correct this situation the Committee approved the substitution of the word "approval" for the word "authorization" as it appeared in the second and third sentences of subparagraph (b) of the ASFR minutes of 17 July 1956. AUG 14 1956

12. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. The Committee considered a report from the Section XV Subcommittee, dated 30 July 1956, presented in response to a report from the Tax Subcommittee dated 21 June 1956. In considering the Section XV Subcommittee's report with respect to the three questions raised by the ASFR Committee and the Subcommittee's suggested treatment thereof, the Committee disagreed with the Subcommittee's clarification of the first question and reinstated the previous language under subparagraph (1) to read:

"...and which are paid or accrued in accordance with generally accepted accounting principles are allowable,  
..."

The Committee further revised the two sentences following (2) (ii) to read:

"Reasonable cost of any such action undertaken by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to assure timely direction after prompt request therefor, are also allowable."

The Committee concurred in the Subcommittee report concerning the other questions. These include retaining the present language of subparagraph (2) (ii) without change and the addition of a proviso provision to subparagraph (3) as follows:

"... , provided any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

As revised above the Committee approved the changes for inclusion in Section XV. AUG 14 1956

3. Case 53-144 . Section XV - 15-204.2(bb) - Training and Educational Expenses  
A report dated 12 July 1956 from the Special Subcommittee established to consider the subject problem was discussed at length. The discussion touched upon many facets of the problem, such as whether the proposed allowance of training and educational expenses was in keeping with the National policy or merely a question of the "cost of doing business" in the present economy. It was pointed out that many commercial concerns have established programs for the advancement of their engineering and scientific employees by supporting their education in after-hour classes and, to some extent, even on a full-time basis at graduate schools. It was further pointed out that it is the President's policy to promote training, particularly higher training, starting at the high school level. In addition, the members were advised that the Hoover Committee had recommended Governmental support and training to encourage Governmental career employees. To some extent, the Army and Navy are now using this practice for certain selected employees.

The Committee then undertook consideration of the proposed paragraph contained in Inclosure 4 of the Subcommittee report, in conjunction with the other inclosures. The paragraph was approved, as modified by the Committee, subject to editing as follows:

"15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks, when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level related to the job requirements of the employee as follows:

1. Tuition, fees, training materials and textbooks.
2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level, related to the job requirements of the employee, for a total period not to exceed one school year. In unusual cases where required by **military technology, the period may be extended.**

d. **The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable."**

The Committee also noted that it may be necessary to include an appropriate cross-reference to subparagraph (d) of 15-204.2(bb) in the listing of items of unallowable costs.

A further question was raised with respect to the treatment of costs occasioned where contractors established schools at their own locations on the premise that such costs ought to be covered by the above paragraph. As these costs would involve both facilities and faculty expenses, the question of how such costs would be treated was returned to the Subcommittee to draft appropriate coverage for inclusion in the above paragraph 15-204.2(bb). The Subcommittee was requested to provide a report for consideration by 7 August 1956. JUL 31 1956

11. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Committee considered a report from the Editing Subcommittee, dated 21 June 1956, presenting an edited version of the subject material. The Committee modified the second and third sentences of subparagraph (b) to read as follows:

..... "On cost-type contracts, and to the extent required by the contracting officer on redeterminable and incentive fixed-price contracts, however, an authorization from the Government for the use of overtime, extra-pay shifts and multi-shifts must be obtained to sustain the charge of any premium labor costs to the contract. Such authorization should generally be obtained prior to the use of overtime, extra-pay shifts and multi-shifts." .....

In the last sentence of subparagraph (b) the word "required" was substituted for the word "desired."

In the title of paragraph 12-102 the word "Shifts" was changed to read "Shift" in the phrase "Extra-Pay Shifts."

As modified, the revised paragraph 12-102 was approved for printing concurrently with the printing of Section XV. JUL 17 1956

4. Case 53-44 - Revision of Section XV - Contract Cost Principles - Part I. The Committee considered a report, dated 6 July 1956, from the Editing Subcommittee presenting an edited version of the revision of Part I, Section XV. After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. A further suggestion was made that when the revised Part I was published a change was required in paragraph 15-502(a) to replace the comma with a period and delete all material following the comma. The Committee approved the recommendation. JUL 24 1956

1. The minutes of the 7/24/56 meeting were approved with the following modification:

Item 4. Case 53-44 - Revision of Section XV - Contract Cost Principles Part I.

The case number was revised to read 56-29, and the second sentence was revised to read: "After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Air Force member of the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. JUL 31 1956

7. Case 53-44 - Revision of Part 2, Section XV. Report dated 21 June 1956 from the Tax Subcommittee, recommending certain changes in proposed paragraph 15-204.2(y) of the latest draft of Part 2, Section XV, was discussed. It was determined that the paragraph should not include a reference to "taxes of foreign governments" since the award of cost-reimbursement type contracts by local procuring activities to foreign contractors occurred so infrequently that this matter should be covered on a case-by-case basis when awards are made to foreign contractors. In the revised draft of the paragraph submitted by the Tax Subcommittee in subparagraph (1) the question was raised as to whether defense would reimburse a contractor for taxes incurred. In subparagraph (2) (ii) the question was raised as to the soundness of the statement, and in subparagraph (3) it was indicated that the last sentence should be a "proviso" sentence. The entire report was referred to the Part 2, Section XV Subcommittee for review, in coordination with the Tax Subcommittee, if necessary, and the request made that a report be submitted within 30 days. JUL 3 1956

13. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). An Editing Subcommittee report dated 21 June 1956 submitted an edited version of a revised ASFR paragraph 12-202. The ASFR Committee discussed the details of this draft and made the following three observations with respect to paragraph (b):

- a. In line 3 it was suggested that there be added after the word "contractor," the following:

", and the contractor shall not be entitled to a price adjustment therefor,";

- b. In subparagraph (ii) discussion concerned having the subparagraph commence "To the extent required by the contract"; and

- c. Having the third from the last sentence read:

"Such authorization shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts."

It may also be necessary to delete the "s" from the phrase "extra-pay shifts" wherever it appears in the entire clause.

The Committee members desired to look into this matter further and, accordingly, the item will be discussed again at next week's meeting.

JUL 3 1956

15. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Secretary was requested to include this item on the agenda for the next meeting. In the interim the members will look further into the matter.

JUL 10 1956

4. Case 53-44 - Revision of Section XV, Part 2. The Chairman announced that the Material Secretaries Council had decided that the subject of profit sharing, contributions and donations, and general research costs would receive the same treatment under the revised Part 2 as in the existing Section XV. It was determined that there was no objection to using the revised language concerning general research costs developed by the Editing Subcommittee; however, with respect to the negotiation criteria set forth in the edited version under general research costs, it was agreed that they would not appear in Part 2 but would be placed appropriately in Part 1 of Section XV. APR 17 1956

9. Case 53-44 - Revision of Section XV, Part 1. The Committee considered a memorandum from the Chairman recommending that when Section XV, Part 2, is revised that certain changes, as set forth, be made simultaneously in Part 1. It was determined that these recommendations be referred to the Editing Subcommittee with the further request that the Editing Subcommittee review the suggested placement of proposed paragraph 15-103. With respect to this latter point, it was agreed that the Committee had previously directed the placing of this material in Part 1, but in reconsidering, the question was presented as to whether it should not more properly be placed in Part 5. The Editing Subcommittee was requested to report within two weeks. MAY 1 1956

11. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. A report from the Editing Subcommittee, dated 26 April 1956, containing a final edited draft of subject was distributed to the members. In addition, a revised draft of a document containing the major unresolved issues with industry were also made available to the members. Both of these documents will be attached to an agenda item for the Material Secretaries Council in the very near future and the members were requested to give their concurrence to the documents to the Chairman by 4 May 1956. MAY 1 1956

12. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). A revision of the subject paragraph, developed by the Staff to conform with the proposed Section XV treatment of overtime, extra-pay shift and multi-shift work, was considered by the members and referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to present a report for consideration by 29 May 1956. MAY 8 1956

5. Case 53-44 - Revision of Part 2, Section XV. A representative of the Tax Subcommittee reported that the Subcommittee had noted several areas not explicitly covered by paragraph 15-204.2(y), entitled "Taxes," which could result in issues with contractors. In view of the current status of Section XV, the Committee requested the Tax Subcommittee to present their written comments in order that these potential deficiencies could be considered. JUN 5 1956

12. Case 56-29 - Revision of Section XV, Part 1.  
Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). The Chairman raised the question of when reports would be received from the Editing Subcommittee with respect to the subject problems. The Navy legal member advised that a report from the Editing Subcommittee on the two subject problems would be presented within one week. JUN 5 1956

1. The minutes of the 6/5/56 meeting were approved with the following modification:

Item 5. Case 53-44 - Revision of Part 2, Section XV. The last sentence was revised to add the words "for subsequent revision of Section XV." JUN 12 1956

Part 5 - Subjects Affecting Cost Which May Require Special Consideration.

"Part 5 - Subjects Affecting Cost Which May Require Special Consideration.

15-500 Scope of Part. This Part enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in Part 3, or Part 4, of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations."

Part 6 - Cost Interpretations.

"Part 6 - Cost Interpretations  
Delete balance of this Part and substitute therefor the word 'RESERVED'."

Part 7 - Facilities Contracts.

"15-700 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for the acquisition of industrial facilities to which the Government takes title under the contract. This Part also applies to clauses in any other cost-reimbursement type contracts or cost-reimbursement type subcontracts thereunder, which clauses provide for the acquisition of industrial facilities to which the Government takes title.

15-701 Applicability. Pending publication of the principles and standards to be incorporated in this Part, Parts 2, 3, or 4 shall be used to the extent appropriate in accordance with Departmental procedures."

The Committee was further advised that a change similar to the change made in Part 4 (15-403 (q)) would also have to be made in Part 3, 15-304 (g). The Committee concurred in such a change.

NOTE: Subsequent to the meeting the following change was received from the Editing Subcommittee for Part 3 - Research Contracts with Nonprofit Institutions:

"15-304 Examples of Items of Allowable Costs. . . .  
(g) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2(q) and group health, accident and life insurance plans (but see paragraph 15-305(k))."

Action to develop a clean draft of Part 2, incorporating the changes approved to date, was deferred until after the Material Secretaries consider the existing three issues.

APR 10 1956

15-204.2 (1) Insurance and Indemnification. (Page 9). This subpara. graph was revised to read as follows:

"15-204.2 (j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise."

15-204.2 (n) (1) and (6) Material Costs. Pages 11 and 12). Were revised to read:

"15-204.2 (n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intramodal insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material; consideration will be given to reasonable overruns, spoilage, and defective work (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work).

\* \* \* \* \*

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower, unless factors other than price warrant allowance on the basis of the cost to the transferor; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the ~~same or substantially similar items, whichever is the~~ lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer."

The Committee further considered proposed revisions of existing Parts of Section XV, together with a new proposed Part 7 covering Facilities Contracts, presented by the Editing Subcommittee, the revisions to be issued simultaneously with the issuance of the revised Part 2. The Committee approved the following revisions:

Part 4 - Construction Contracts.

"15-403 Examples of Items of Allowable Costs. . . . .

(q) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2 (q) and group health, accident and life insurance plans (but see paragraph 15-404 (b), (d), and (m))."

CONT'D  
NEXT  
PAGE



contractor's products, or other relevant circumstances.

Individual categories of indirect cost are discussed in ASFR 15-203.2 through 15-203.5."

15-200. The Committee approved a revision of the TITLE and the "Scope of Part" as quoted below:

"Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors other than such contracts and subcontracts to which Parts 3, 4, or 7 apply."

15-204.2 (f) (2) Depreciation. (Page 7). This subparagraph was revised to read as quoted below:

"\* \* \* \* \*

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed:

- (i) upon the property cost basis used by the contractor for Federal income tax purposes (See Section 167 of the Internal Revenue Code of 1954); or
- (ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income tax; and in either case
- (iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations."

The Air Force withdrew its former request for consideration of additional language to be added to subparagraph (iii) which would, in effect, have provided that the depreciation allowable under a contract would not exceed the depreciation authorized under the Internal Revenue Code. This action was taken on the premise that the disadvantages of holding contract files open for an indeterminate period of time until final determinations of depreciation had been made by tax authorities or by the Courts outweighed the advantages sought by the additional language.

APR 10 1956

CONT'D  
NEXT  
PAGE

4. Case 53-44 - Revision of Section XV. Consideration of the special areas subject to revision or review at the Special Meeting held 4/6/56 was undertaken in the following order:

15-204.2 (p) Patents. (Page 12). The last line of the edited draft, dated 29 March 1956, was revised to delete the words "by the Government" and substitute therefor the words "where title is conveyed to the Government."

15-204.2 (o) Overtime. (Page 12). The members were advised that the OASD (M&P) had no objections to revising ASFR paragraph 12-102 to be consistent with this paragraph. Accordingly, the Staff will prepare a revision of 12-102 for consideration.

15-203.5 General and Administrative Costs. (Pages 4 and 5). This paragraph was revised to read as follows:

"15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs) is a method which generally produces equitable results. Other methods acceptable where the circumstances are appropriate include allocation on the basis of:

- (i) processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct materials);
- (ii) factory input costs (processing costs plus direct material);
- (iii) cost of goods completed;
- (iv) cost of sales; and
- (v) sales (where no more satisfactory method is available)."

15-203.1 (b) General. (Page 3). This subparagraph was revised to read as follows:

"15-203.1 (b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, provide uniformity of treatment for like cost elements, be applied consistently, and produce equitable results. A previously acceptable method shall be subject to reconsideration when:

- (i) Any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or
- (ii) Any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs; the inventories, the volume of sales, the volume of production, manufacturing processes, the

APR 10 1956  
CONT'D  
NEXT  
PAGE

Page 21. 15-204.2 (aa) (1). The third word reading "contractor's" was deleted.

15-204.2 (bb). This paragraph was reserved. A Special Subcommittee was established to consider this problem as a special case, presenting a revised coverage on the subject of training costs. In taking this action the Special Subcommittee was requested to give consideration to inclusion of a reference on page 26 when their efforts are completed. The Subcommittee was further requested to coordinate their efforts with the OSD Office of Manpower Supply. Members designated to the Subcommittee were:

Army - To be designated

Navy - Mr. A. C. Sawallisch, ONM (Chairman)

Mr. James Ruttenberg, OCN

AF - Mr. P. M. Southwell, AFMPP

Mr. W. L. Latta, AFAUD

The Subcommittee was requested to present a report for consideration by 7 May 1956.

Page 22. Approved.

Page 23. Approved.

Page 24. 15-204.3 (i). The Committee deleted the reference in parentheses at the end of this paragraph. In taking this action, there was general agreement to specifying the period and amount in part 1 when rewritten, with an appropriate cross-reference.

Page 25. Approved.

Page 26. 15-204.3 (2) (xi). The words "special tooling costs" were deleted and the word "taxes" substituted therefor.

15-204.2 (2) (xii), Training Costs, was deleted in its entirety.

15-204.2 (2) (xiii), Travel Costs, was renumbered to (xii).

The Navy legal member called the Committee's attention to the Editing Subcommittee's report of 27 February 1956, in paragraph 4 of which the Subcommittee covered the subject of side agreements. It is understood that this matter had been the subject of discussion by the Procurement Secretaries in the spring of 1955.

With the above action, further consideration of this subject was deferred until the next meeting to be held 4/10/56.

APR 6 1956

As revised the paragraph was referred to the Editing Subcommittee, with the request that the edited language be presented by the next regular meeting (10 April 1956).

15-204.2 (n) (6). The semicolon following the phrase "whichever is lower" was changed to a comma and the following language added:

"unless factors other than price warrant allowance on the basis of the cost to the transferor;"

Page 12. 15-204.2 (n) (6). The word "either" appearing before (i) was deleted. The period at the end of the paragraph was changed to a comma and the following language was added:

"whichever is lower, unless factors other than price warrant allowance on the basis of the cost to the transferor."

15-204.2 (n). The Staff will undertake action to determine whether a revision to paragraph 12-102 may be made in order that paragraph 12-102 be consistent with this paragraph.

15-204.2 (p). The Staff was requested to clear the need with the Patents Advisor of the inclusion of the words "or on behalf of" in the last line.

Page 13. Approved.

Page 14. 15-204.2 (q) (3) (iv). The Committee agreed to the inclusion of a note in the Minutes that under this paragraph the parties can agree to (A) or (B) for the individual periods under the contract.

15-204.2 (q) (3) (iv) (A). The second word "all" was deleted.

Page 15. 15-204.2 (q) (3) (iv) (B) (II). The words "or gains" were inserted after the word "credits" in the sixth from the last line.

Page 16. Approved.

Page 17. 15-204.2 (u). The words "such factors as" were inserted between the words "of" and "the" in the second line.

15-204.2 (v) (2). This paragraph was reserved.

Page 18. Approved, subject to deletion of brackets in 15-204.2 (v) (3).

Page 19. Approved.

Page 20. Approved.

APR 6 1956

CONT'D  
NEXT  
PAGE

Page 4. Delete a comma in paragraph 15-203.2.

Paragraph 15-203.5. The Air Force member recommended that everything after the first two sentences of this paragraph be deleted. After considerable discussion this recommendation was rejected. However, subparagraph (i) was deleted in its entirety. Subparagraph (ii) was referred to the Audit members of the Section XV Subcommittee for clarification, with the request that the revised language be presented for consideration at the next regular meeting (10 April 1956). Final decision will be made on this paragraph after revised (ii) is reviewed.

Page 5. ~~Approved.~~ ~~barrier saw danger of being~~ ~~subcommittee~~

Page 6. Approved, reserving subparagraphs (d) and (e) of 15-204.2.

Page 7. 15-204.2 (f) (2) (i) (ii) (iii). These subparagraphs were revised to read as follows:

"(i) is computed upon the property cost basis used by the contractor for Federal income tax purposes (See Section 167 of the Internal Revenue Code of 1954); or

(ii) in the case of nonprofit or tax exempt organizations, upon a cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income taxes, and

(iii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954. In no event, however, shall a greater amount for depreciation be allowed than is authorized by the Internal Revenue Code."

The Navy member objected to the addition of the underscored language pending further study.

As revised, this paragraph was referred to the Editing Subcommittee for editing, with the request that the edited paragraph be presented for consideration by the next regular meeting (10 April 1956).

Page 8. Approved.

Page 9. Was approved, subject to further editing of the last sentence of paragraph 15-204.2 (j) (1), which was referred to the Editing Subcommittee with the request that the edited language be presented by the next regular meeting (10 April 1956).

Page 10. Approved, subject to the deletion of a comma in 15-204.2 (k) (1) (2).

Page 11. 15-204.2 (n) (1). This subparagraph was modified to add the following words in parentheses:

"(for correction or defective work see the clause of the contract relating to 'Inspection and Correction of Defective Work')." APR 6 1956

CONT'D  
NEXT  
PAGE

53-44

Revision of Section XV,  
Contract Cost Principles

Editing

JAN 31 1956

The members were advised  
a report on this problem  
would be presented by  
14 February 1956.

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. A report of the Chairman of the Editing Subcommittee pointing up certain areas requiring resolution prior to final editing was noted and further consideration deferred until the next meeting. In the interim the Editing Subcommittee was requested to meet with the Section XV Subcommittee in an effort to resolve as many of the areas as possible and to report on their accomplishments at the 6 March 1956 meeting. FEB 28 1956

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Chairman advised the members that the Editing Subcommittee was still studying the problem which had arisen with respect to "Pension Plans" and that it was contemplated a report would be presented in the near future. When the report is received the members will be contacted to determine the need of a special meeting to consider the problem. MAR 6 1956

5. Case 53-44 - Section XV - Contract Cost Principles. The Committee determined to hold a special meeting Friday, 16 March 1956, at 1100 hours, in room 2216, Main Navy Building, to consider the report of the Editing Subcommittee on this problem. MAR 13 1956

11. Case 53-44 - Revision of Section XV - Part 2. The Chairman of the Editing Subcommittee advised the members of the progress to date of the joint efforts of the Editing Subcommittee and the Section XV Subcommittee in completing the editing of Part 2 of Section X. In view of the Committee's action it was determined that no special meeting would be held Friday, 23 March 1956, to consider this problem but that the report, if available, would be considered at the next regular meeting. MAR 20 1956

The Army member expressed an inability to ascertain what the phrase "Commercial Type Accounting Systems" encompassed. In this connection he wished it made a matter of record that if the section is to be meaningful a definition of this phrase should be included.

13. Case 53-44 - Revision of Section XV, Part 2. The Chairman of the Editing Subcommittee advised that revised copies of this part jointly being considered by the Section XV Subcommittee and the Editing Subcommittee would be available by Friday, 30 March 1956. In this connection, the Chairman expressed a desire that the revised report could be considered at the next regular meeting to be held 3 April 1956.

The Chairman further advised the members that instructions to the Staff with respect to the three issues covering

Profit Sharing,  
Contribution and Donation, and  
General Research

MAR 27 1956

were to be accorded the same treatment now provided in the current Section XV.

4. Case 53-44 - Revision of Part 2, Section XV. A Staff proposal presenting a revision of paragraph 15-204.15, Insurance and Indemnification, was considered, approved after minor modification and referred to the Editing Subcommittee as shown below:

"15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Department concerned.

(iv) Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For example, see ASPR 7-203.22). Except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self insurance program or otherwise), are not allowable."

In further considering paragraph 15-204.34(b)(1) the Committee questioned the advisability of providing for an allocation of cost to all general research work of the contractor if the concept of providing for an allowance of the cost is specifically covered in the contract. The Committee determined that as long as this concept is retained no provision for an allocation was required. Accordingly, subparagraph (A), reading as follows, was deleted:

"(A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research."

With this action corrected copies of Part 2 of Section XV were distributed to the legal members for their respective members of the Editing Subcommittee in order that editing of the draft could be undertaken. The Editing Subcommittee was requested to provide a report for consideration by 13 January 1956.

DEC 13 1955



15-204.2.1 The seventh sentence was revised to read:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing for retrospective accounting and any necessary adjustment to the pension plan cost incurred under the contract."

With this modification the paragraph was approved.

15-204.8 Contributions and Donations. Copies of the Air Force minority position with respect to this paragraph, which was isolated as an issue at the 11/22/55 meeting, were distributed to the members for presentation to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue.

As modified by the ASPR Committee the Subcommittee report was referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to provide a report for consideration by 10 January 1956. To facilitate editing, the Staff will provide the members of the Editing Subcommittee with a clean draft of the report.

DEC 6 1955

2. Case 53-44 - Revision of Part 2, Section XV. In approving the minutes of the 12/6/55 meeting the Air Force requested that the last sentence under paragraph 15-204.35, Royalties and Other Costs for Use of Patents, be revised to express the concept in two sentences rather than one. Accordingly, this sentence was rephrased as follows:

"Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. Charges for the use of Patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract."

DEC 13 1955

The Subcommittee report of 1 November 1955 was further considered on a paragraph basis, as follows:

15-203.3 presented by the Subcommittee was approved. A Staff proposal to revise this paragraph was rejected.

15-204.15 - Insurance and Indemnification. A revised outline of this paragraph developed by the Army legal member, was distributed to the members. Considerable discussion centered around the variance in the language of the first two sentences of subparagraph b. and the language contained in the clause, insurance - liability to third persons. The Committee requested the Subcommittee Chairman to redraft the entire paragraph to achieve consistency and a cross-reference of the clause and present same at the next meeting.

15-204.34b(i) Copies of a revision to this paragraph starting with the third sentence, developed by the Air Force member, were distributed to the members. The paragraph was then discussed at length. As a compromise the Committee revised (i) under paragraph b to read as follows and tentatively approved the paragraph, subject to editing, the Navy and Staff positions being reserved:

"(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.

(A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.

(B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.

of such independent general research shall be given

- a. Scope, nature and quality of the contractor's independent general research program.
- b. The capability of the contractor in the particular research field.
- c. Benefits which may accrue to the Government.
- d. Comparison of size and cost of contractor's previous years' research programs.
- e. The proportion of the Government business to the contractor's total business."

In considering the paragraph the Committee also determined that the Government's position versus Industry's position with respect to general research should be presented to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue with industry.

15-204.34b(11) approved.

15-204,340 approved.

15-204.260 The second sentence was revised to read:

"Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal Income Tax purposes in the current taxable year."

With this modification the paragraph was approved.

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NEXT  
PAGE

1. a. The minutes of the 11/22/55 meeting were further modified as follows:

Item 3. Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.24. The paragraph was revised to read:

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as allowable either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

- b. The minutes of the 11/29/55 meeting were approved with the following revisions:

Item 2 - Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.34b(i) was revised to read:

"A proposed subparagraph c. presented by the Staff was considered and rejected. In lieu thereof the Committee suggested the insertion of the following first parenthetical expression in the third sentence of (i) which would read as follows:

"The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"

However, the positions of the Departmental members with respect to this change was reserved." DEC 6 1955

2. Case 53-44 - Division of Part 2, Section XV. Copies of a memorandum from the Subcommittee Chairman presenting revisions of paragraphs 15-204.25, 15-204.29c, 15-204.34d and 15-204.35 were distributed to the members and the following action taken on the revised paragraphs:

~~15-204.25 was revised as follows:~~  
"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

As revised the paragraph was approved, subject to editing.

15-204.29c reading as follows was approved:

"15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government are unallowable. The costs of legal, accounting and consulting services and related expenses incurred in connection with patent infringement litigation are unallowable unless otherwise provided in the contract."

15-204.34d reading as follows was approved:

"15-204.34 RESEARCH AND DEVELOPMENT

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

15-204.35 reading as follows was approved:

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent, or a patent has been adjudicated to be invalid, are unallowable unless otherwise provided in the contract."

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DEC 6 1955

2. Case 53-44 - Revision of Part 2, Section IV. The Committee considered certain points in the Subcommittee draft that required action subsequent to that taken by the Committee in its 11/22/55 meeting. These points covered the following subparagraphs:

15-203.5 - The paragraph was revised and approved to read as follows:

"The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year."

15-204.8 - The Air Force member advised that the Air Force position for presentation to the Material Secretaries on this problem would be presented within one week.

15-204.25 -

15-204.34d -

15-204.35 - A memorandum from the Patents Subcommittee setting forth the views of the Patents Subcommittee with respect to these paragraphs was distributed to the members. After a brief discussion the problem was returned to the Section IV Subcommittee for further consideration in conjunction with the Patents representatives of the three Departments. The Section IV Subcommittee was requested to provide an interim report at the next meeting and a final report by 13 December 1955.

15-204.33b - Two alternative proposals to subparagraph b. of this subparagraph were distributed by the Navy member. After discussion the Committee adopted

the proposal quoted below. The proposal was adopted by a vote of 10 to 2.

otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) borne by the lessor which would have been incurred had the contractor retained legal title to the facilities."

15-204.34b(1) - A proposed subparagraph (c) presented by the Staff was considered and rejected. In lieu thereof the Committee inserted the following first parenthetical expression in the third sentence of (1), which reads as follows:

"The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"

15-204.15f - The Committee determined to place a period after the word "allowable," deleting the words "unless approved by the Department concerned," subject to editing. The Army legal member was requested to present revised phraseology for this paragraph f. for consideration at the next meeting.

15-203.3 - Consideration of this paragraph was deferred until the next meeting in order that the reaction of the Small Business interests could be obtained.

NOV 29 1955

1. The minutes of the 22 November 1955 meeting were approved with the following modifications:

Item 3. Case 53-44 - Revision of Part 2, Section XV. The first sentence was revised to read:

"In considering the Subcommittee report of 1 November 1955, and the undated Army Audit Agency report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted."

The following paragraphs were adopted as presented by the Subcommittee:

15-202.1  
15-202.2  
15-202.3  
15-203  
15-203.1

Subparagraph 15-204.8. The first sentence was revised to read:

"The Air Force member stated that the problem will be particularly difficult in cases involving industries involved primarily in defense work, such as the aircraft industry. In those cases, contributions and donations, for all practical purposes will be made by the Government and not by the contractor, to such beneficiaries and in such amounts as is determined by the contractor. Therefore, the Air Force position is for continuing the disallowance as in the present ASFR."

Subparagraph 15-204.15. The quoted addition to subparagraph "a" was revised to read:

"The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (for example, see ASFR 7-203.22)."

Subparagraph 15-204.18. A parenthetical expression was added at the end of the first sentence, as follows:

"(including the contractor's contributed portion under cost-sharing R&D contracts)."

With this addition the minutes were revised to read:

"The Committee adopted the Subcommittee position as clarified that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts."

15-204.26d. The penultimate word in the quotes was revised to read "reversionary."

15-204.28 - The second sentence of the paragraph on precontract costs was revised to place a period after the word "contract" and to delete the words "and may be limited to a period of time as well as to the type and amount of such costs."

The minutes were revised to read:

"The Committee accepted the draft as modified."

formula approach set forth in the draft but there was also a general feeling that an appropriate method of control be further explored."

NOV 29 1955

- 15-204.27 - The Committee accepted the draft as written.
- 15-204.28 - The Committee accepted the draft as written.
- 15-204.29 - With respect to subparagraph "c," the Committee adopted the position of the Subcommittee that such legal fees are not allowable.
- 15-204.30 - The Committee adopted the position of the Subcommittee that all profits and losses on disposition of plant, equipment or other capital assets be excluded in computing contract costs.
- 15-204.31 - The Committee adopted the Subcommittee position that specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the interests of the Government and the Contractor.
- 15-204.32 - The Committee accepted the draft as written with the exception that the second sentence was revised to read as follows:
- "It further includes the costs of operating an aptitude and educational testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment."
- 15-204.33 - With respect to subparagraph "b," consideration was given to the change recommended by the American Institute of Accountants. Mr. Ruttenberg was requested to draft substitute language for submission to the Editing Subcommittee.
- 15-204.34 - The Committee discussed at length the Subcommittee approach with respect to general research. There was general agreement in the formula approach set forth in the draft but there was also a general feeling that a dollar ceiling be coupled with such approach. Using this as a basic concept, the Staff was requested to develop a proposition for further consideration.
- 15-204.35 - The Committee adopted the position of the Subcommittee that payments of royalties to contractors should be circumscribed by contract provision or otherwise authorized by the Contracting Officer.
- 15-204.36 - The question was presented as to whether at least the protection afforded the Government in proposed ASPR 15-202.1 should not be provided. However, it appeared that the protection sought should be related to the "Inspection of Supplies and Correction of Defects" clause (ASPR 7-203.5c). The Army member recommended that the Editing Subcommittee give consideration to insertion of the word "consumer" after "training" in the phrase "and training personnel in the use,".
- 15-204.37 - The Committee accepted the draft as written.

CONT'D  
NEXT  
PAGE



15-204.22 - The Committee concurred in the recommendation to include "accountants fees" immediately after "attorneys fee" in the second sentence of the paragraph.

15-204.23 - The Committee accepted the draft as written.

15-204.24 - The Committee adopted the Subcommittee position with respect to identification separately of shift premium and overtime. However, the paragraph was changed to read as follows:

"15-204.24 OVERTIME, EXTRA PAY, SHIFT AND MULTI-SHIFT PREMIUMS. This item consists of the premium portion of extra pay and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as government work. See ASFR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost."

15-204.25 - The Committee deferred consideration of this paragraph and the parenthetical expression in 15-204.3d until the next meeting.

15-204.26 - The Committee accepted the draft as written with the exception of the following changes:

15-204.26c - The second sentence was revised to read as follows:

"Such costs may include excess contributions made in previous years to the extent such contributions are claimed and allowed for tax purposes in the current taxable period.

15-204.26d - The next to the last sentence was revised to read as follows:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and refund of any necessary credits."

15-204.26e - This subparagraph was revised to read as follows:

"The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than incurred under approved pension plans will be subject to consideration on an individual case basis."

NOV 22 1955  
CONTY  
NEXT  
PAGE

13. Case 53-44 - Revision of Section XV. The member noted the designation of Maj. J. O. Hunnicutt, Jr., DEP ICG, as Army member of the subject Subcommittee, vice Lt. Col. J. M. Railing, DEP ICG. FEB 1 1955

1. Case 53-44 - Revision of Section XV. Copies of a proposed DOD Instruction, developed by the Office of the CSD Comptroller, to provide guidance with respect to depreciation in keeping with Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness, were distributed. After a brief discussion, the Committee concluded that it should be highly desirable to incorporate the policy in the Regulations if possible, rather than have it published as a DOD Instruction. To achieve this end, the Section XV Subcommittee was requested to develop appropriate coverage of the proposed Instruction in Part 6 of Section XV, or submit recommendations as to other media for publication, including a recommendation with respect to the proper document for use for the other media.

In taking this action the Committee agreed that modification of the depreciation paragraph (15-204.9) to incorporate the principles of the proposed directive should be postponed until after receipt of comments from industry on the proposed Section.

The Subcommittee was requested to provide a report for consideration by 15 March 1955. MAR 1 1955

4. Case 53-44 - Revision of Section XV, ASFR. A report from the Section XV Subcommittee, presenting a proposed depreciation - cost interpretation for inclusion in Part 6 of Section XV, was concurred in in principle, subject to editing. In taking this action the members noted three areas requiring further consideration:

- a. Effective date.
- b. Inclusion of the text of Section 167 of the Internal Revenue Code of 1954, and
- c. Omission of any reference to "true" depreciation.

The above areas were referred to the Editing Subcommittee for consideration in conjunction with editing the proposal. The Staff volunteered to develop a cross-reference to "true" depreciation for consideration by the Editing Subcommittee. The Editing Subcommittee was requested to provide a report for consideration by 29 March 1955. MAR 1 1955

10. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASFR. A report from the Editing Subcommittee, presenting the subject interpretation, was discussed at length. The report was returned for reconsideration. While the Committee did not finally determine its position, the Editing Subcommittee should redevelop the project along the following lines:

- a. Applicability of the interpretation. In the absence of a specific agreement the interpretation applies to all "open" contracts.
- b. With respect to the assets involved. Undertake interpretation, thinking in terms of the description of the assets covered, utilizing therefore the provisions of the statute.

Consider again the desirability of quoting or paraphrasing such of the statute as will render the depreciation cost interpretation generally understandable in itself. APR 5 1955

15-204.38 - The Committee accepted the draft as written with the exception that the Army member recommended that the Editing Subcommittee consider revising the definition of "special tooling" to conform with that currently being proposed by the Section XIII Subcommittee.

15-204.39 - The Committee adopted the Air Force minority position with respect to subparagraph 15-204.39a(3), and that of the Subcommittee on 15-204.39b.


15-204.40 - The Committee adopted the Subcommittee position with respect to the non-allowability of costs incident to exhibitions.

15-204.41 - The Committee accepted the draft as written.

15-204.42 - The Committee accepted the draft as written with the exception that the Army member requested that the Editing Subcommittee consider that line 5 of the second paragraph be revised to read: "\* \* \* provided the contractor follows a consistent procedure which provides for equitable results in this respect."

15-204.43 - The Committee accepted the draft as written.

With respect to the third observation set forth in the first page of the Subcommittee report, the conclusion was reached that Departmental implementing instructions should follow within a reasonable time the publishing of Part 2, Section XV. The Committee also determined that final consideration of Part 2 would be given at a subsequent meeting, but as soon as possible.



NOV 22 1954

6. Case 53-44 - Revision of Section XV. The members noted copies of the comments received from industry on the proposed revision of the subject Section. The Committee Chairman requested the Departmental members to impress upon their respective Subcommittee members the need for expeditious completion of this project. JUL 26 1955

15/ Case 53-44 - Revision of ASPR Section XV. The members noted an interim progress report from the subject Subcommittee, included on the agenda. The Committee extended the time for a final report until 27 October 1955. OCT 4 1955

*see agenda for this date*

3. Case 53-44 - Revision of Part 2, Section XV. Consideration of a report from the Section XV Subcommittee, presenting a revision of Part 2, Section XV, was deferred at the request of the Air Force member until the meeting of 22 November 1955. NOV 8 1955

3/ Case 53-44 - Revision of Part 2, Section XV. In considering the Subcommittee report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted. The action of the Committee resulted in the following:

15-200 - In considering the industry position that a statement be included to the effect that Section XV is not applicable to fixed-price contracts, including those with price redetermination provisions, the question was presented as to whether it was necessary to preclude the application of the principles to certain types of contracts. It was stated that a separate Part for Section XV will be developed to cover facilities contracts. The Committee determined that the "Notes and Filing Instructions" covering the ASPR Change which will include Part 2 should contain a note that the use of the principles is not precluded in connection with facilities contracts pending publication of that Part of Section XV which will cover facilities contracts.

15-201 - The Committee adopted the Subcommittee position that the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs" is only one of the factors affecting allowability of costs and does not take anything away from the contractor.

15-202 - Accepted the draft as written.

15-203.2 - Discussion centered around the parenthetical phrase "(including independent research projects)" as set forth in 15-203.2, the Air Force recommendation with respect thereto, and the relationship of the phrase to 15-204.34c. It was the determination of the Committee that the stated phrase should be deleted and that "(see ASPR 15-204.34c)" should be inserted in lieu thereof. The Committee also determined that the second parenthetical phrase in 15-203.2 "(exclusive of overtime premium)" should be changed to read "(exclusive of overtime, extra pay, and multi-shift premium)".

NOV 22 1955

CONT'D  
NEXT  
PAGE

15-204.10 - The Committee accepted the draft as written.

15-204.11 - The Committee adopted the Subcommittee position that entertainment expense should not be allowed and that there was no conflict between this paragraph and 15-204.10 and 15-204.10.

15-204.12-14 - The Committee accepted the draft as written.

15-204.15 - In accordance with the point expressed by the Army member, the Committee determined that subparagraph "a" should provide some coverage with respect to indemnification. It was decided that proposed subparagraph "g" should be deleted and that such coverage, revised to read as follows, should be inserted at the end of subparagraph "a".

"The cost of indemnification will be allowable only to the extent expressly provided for in the contract (for example, see ASPR 7-203.22)."

It was also determined that subparagraph "c" should be revised to read as follows:

"c. The costs of insurance or any reserve covering the risk of loss or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve."

With these changes, and especially that concerning indemnification, the Editing Subcommittee should review the paragraph with respect to coverage given these cost elements.

15-204.16 - The Committee adopted the Subcommittee position that interest be an unallowable cost.

15-204.17 - The Committee accepted the draft as written.

15-204.18 - The Committee adopted the Subcommittee position that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts.

15-204.19 - The Committee adopted the Subcommittee position that any recognition of cost of deferred maintenance expenses through contract provision is proper.

15-204.20 - The Committee accepted the draft as written.

15-204.21 - The Committee adopted the Subcommittee position that cash discounts not be considered as financial income. The Air Force member withdrew the Air Force minority position concerning subparagraph "b." With respect to subparagraph "d," the Committee concluded the subparagraph should consist of only the first sentence as set forth in the draft. The Committee also adopted the Subcommittee position with respect to the non-allowability of the cost of write-down of inventory value.

NOV 22 1954  
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NEXT  
PAGE

15-203.3 - The Committee discussed the proposition of whether any selling expense is properly allocable to a Government contract. There was no question that selling and distribution expenses as related to sales of the products of a company to commercial customers should not be allowed. The Committee concluded that the paragraph as written should remain, subject to the Staff discussing the proposition with the Small Business Advisor to the Assistant Secretary of Defense (S&L).

15-203.4 - The Committee considered that the listing of ~~illustrative factors to be considered in~~ determining whether a method of distributing general and administrative expenses was helpful and should remain in the paragraph.

15-203.5 - The Committee concurred in the Subcommittee position that there was no inconsistency between this paragraph and 15-203(b). The paragraph was, however, revised to read as follows:

"The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs."

15-204 - The Committee accepted the paragraph as written.

15-204.1 - The Committee adopted the Subcommittee position that the proposed instructions with respect to allowance of costs of advertising were not too restrictive.

15-204.2-5 - The Committee accepted the draft as written on these paragraphs.

15-204.6 - The decision with respect to the DOD position on profit sharing is expected within the near future.

15-204.7 - The Committee accepted the draft as written.

15-204.8 - The Air Force member stated that because experience had demonstrated the difficulty of controlling these expenses it was the position of the Air Force that contributions and donations not be allowable as costs. The Air Force was requested to present its revised position to be used in connection with the presentation of an item for decision by the Material Secretaries and the Assistant Secretary of Defense (S&L).

15-204.9 - With respect to subparagraph "e," the Navy member withdrew the Navy minority position. In the discussion which followed, the Committee determined that the following should be inserted as the third sentence in subparagraph "e":

"The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period."

The Editing Subcommittee may improve upon the verbiage of the concept expressed in the insertion.

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PAGE

5. Case 53-44 Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A report from the Editing Subcommittee was briefly discussed and further consideration deferred until the next meeting to permit the Editing Subcommittee to consider an alternative redraft of paragraph 15-602.1, which is quoted below:

"15-602.1 Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204 (d), 15-205 (b) and 15-205 (c). It is effective with respect to existing and future contracts; provided that, as regards existing contracts this interpretation shall not be applicable in any case where there is an express agreement in writing that a different interpretation shall be applicable." MAY 3 1955

2. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A redraft of the proposed paragraph 15-602.1, Applicability and Effective Date, was distributed to the members. After discussion the redraft was slightly modified and approved. The Committee further modified the last sentence of paragraph 15-602.2. Subject to these modifications, the Committee approved the Cost Interpretation for printing. In taking this action the Committee concurred in the issuance of a Press Release announcing the Cost Interpretation, by the Staff, and in the Departments promulgating the Interpretation within their Departments prior to its publication in the Regulation. The Interpretation, as approved, is quoted below:

"15-602 - Depreciation.

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(c). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to pre-determined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation," as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

MAY 10 1955



1. The minutes of the 12/21/54 meeting were approved with the following

First sentence. Prior to discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information and resolution where appropriate:

- a. Major differences with industry.
- c. Those areas in which the Services are not in accord.

15-204.6 - Compensation for Personal Services.

The Committee reviewed the proposal of the Subcommittee as contained in their report of December 15, 1954 and agreed that the proposed subparagraph (c) should be changed as follows:

15-204.6 (e), (f) and (g).

The Air Force nonacceptance of the principle set forth in these subparagraphs results in classifying this as an issue. (The issue, briefly stated, being whether contractor payments pursuant to Profit Sharing and Stock Bonus Plans determined by profits are merely compensation measured by profits and are allowable for reimbursement, or whether payments pursuant to such plans are distribution of profits and therefore are not reimbursable as costs.) To be resolved by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

~~15-204.9 - Depreciation.~~ The Committee considered comments of the Subcommittee relative to the effect of new revenue legislation (Section 167 of the Internal Revenue Code of 1954) on the existing provisions of Section XV. It was generally agreed that the ASFR provision remain unchanged, that a press release be arranged on the topic for information to the public, and that contemporaneously with the press release, appropriate instructions be promulgated to field audit personnel.

15-204.9 (e) b.

"The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facilities."

15-204.27 (f) - Pension and Retirement Plans.

After considerable discussion of reversion credits and the methods by which arrangements can be made that are equitable to the Government, there was general agreement that the paragraph remain as written, but that the attention of the Assistant Secretary of Defense, OASD (S&L), and the Procurement Secretaries be directed to the difficulty of this issue. It is also to be explained that part of the draft will be issued as an instruction, as it is not appropriate as a cost principle. The Navy member agreed to frame the issue, to be inclusive of mass severance pay, and forward copies thereof to the Army and the Air Force.

15-204.41 - Taxes.

- (a) (1) After the third word "taxes" of the subparagraph add ("including state income taxes.")

NOTE: Underscoring denotes change.

JAN 4 1955

7. Case 53-44 Revision of Section XV. Prior discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information:

- a. Major past differences with industry,
- b. Those areas involving a change from the current ASPR position, and
- c. Those areas in which we are not according to industry the treatment desired by them.

The members then commenced discussion of the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and Other Food Services.  
Principle modified and agreed to.

15-204.6 - Compensation for Personal Services.

The Committee reviewed the proposal of the Subcommittee and agreed that the proposed subparagraph (c) should be changed as follows:

- a. At the end of the introduction to subparagraph c., change the colon to a comma and add the following:

"in addition to those set forth in subparagraph (d) (1), (2), (7), and (g) below:"

- b. Revise subparagraph (iii) to read as follows:

"for allowance purposes, the cost of stock options will be amortized equally over an appropriate period from the date the option is exercised depending upon the terms of the option agreement."

The members accepted the proposal of the Subcommittee to delete the second sentence of 15-204.6 (d) (2).

15-204.6 (e) and (f). The Air Force nonacceptance of the principle set forth in these subparagraphs results in clarifying this as an issue (the issue, briefly stated, being whether contractor costs in Profit Sharing and Stock Bonus Plans are merely compensation measured by profits and are allowable for reimbursement, or whether such plans are distribution of profits) to be resolved by the Assistant Secretary of Defense (S&I) in conjunction with the Procurement Secretaries.

DEC 21 1954

15-204.37 b (1) (iii) - General Research.

15-204.38 - Severance Pay.

15-204.41 - Taxes.

The members further determined to delete from the revision, paragraph 15-204.40 - Strikes and Lockouts - Expenses of.

In addition to the above issues the Subcommittee was requested to clarify the language contained in the following subparagraphs:

15-204.22 - Materials and Supplies.

Subparagraph b - re discounts, and

Subparagraph d - re pricing of materials in stock where replacement cost differs significantly from book cost.

A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954.

The subject of clearing the proposed revision with the Comptroller General's office was discussed. It was concluded that it would be highly desirable to informally present a copy to the GAO at the same time the proposal is referred to industry for comment. NOV 30 1954

3

DEC 2 1954  
DEC 6 1954

A. B. C.

1. a. The minutes of the 11/30/54 Regular Meeting, and the Special Meetings held 12/2/54 and 12/6/54, were approved with the following modifications:

- Item 5. Case 53-44 - Revision of Section XV - Contract Cost Principles. The entry 15-204.14 - Profit Sharing, in the second paragraph, was revised to read:

~~"15-204.14 - Profit Sharing (Profit Sharing)"~~

The fourth paragraph was revised to insert a subparagraph e, as follows:

"Subparagraph e - Intercompany or Interdivisional Sales or Transfers," in lieu of subparagraph b.

The fifth paragraph was revised to read as follows:

"A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length, agreed to in principle, and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954."

DEC 4 1954

1. The minutes of the 10/26/54 meeting were approved with the following modifications:

Item 2. Case 53-44 - Revision of Section XV - Cost Principles.  
The last sentence was revised to read:

"The Air Force tentatively approved the principles for the purpose of going forward but reserved the right to review both areas when a final Subcommittee report is issued."

(Underscoring denotes change). NOV 2 1954

8. Case 53-44 - Revision of Section XV, Contract Cost Principles. The Air Force member presented the problem of the allowability for reimbursement of contract costs under cost-reimbursement type contracts and as to the recognition in price under fixed-price contracts of depreciation on plant and equipment computed in accordance with the Internal Revenue Act of 1954. The members recognized the issue, but indicated that coverage had been considered by the Section XV Subcommittee in developing Part II of Section XV. Members will consider this Part at the 11/30/54 meeting. NOV 17 1954

5. Case 53-44 - Revision of Section XV - Contract Cost Principles. Consideration of a report from the Subcommittee, presenting the latest draft of Part 2, Section XV, revised in the light of comments received from the military departments and guidance from the Committee, began with the discussion of the purpose of considering the report. It was agreed that this review would highlight two types of issues for resolution prior to forwarding the revision to industry for comment. These are:

- a. Issues in which the Departmental positions are unknown and which may be resolved by the Committee at a subsequent meeting, and
- b. Issues where the Departmental positions are known which will require resolution by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

The members undertook consideration of the Subcommittee report on a page by page basis. Issues for further consideration appeared in the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and other Food Services -

15-204.6 f - Stock Bonus Plans.

15-204.8 - Contributions and Donations.

15-204.9 - Depreciation.

15-204.14 - Profit Sharing.

15-204.16 e - Insurance - Officers, Partners, or Proprietors.

15-204.17 - Interest and Other Financial Expenses.

15-204.27 f - Pension and Retirement Plans. (In connection with this issue, the Navy member urged that consideration be given to the deletion of pension reversion credits and mass severance pay from the cost principles, presenting the proposal of the coverage of these subjects to industry in a separate paper, stating that both these items were deleted on the premise that one offsets the other. However, if industry insists on one, the Government will insist on the inclusion of both.)

2. C 53-44 - Revision of Section XV - Contract Cost Principles. The Sect. IV Subcommittee was present and submitted a written and oral report on the activities of the Subcommittee to date. Several features of the Section XV revision were discussed. It was agreed that greater emphasis should be placed on the revision and the Subcommittee will meet two days a week to expedite completion. The target date of 1 June 1954 was established for completion of the Subcommittee's work. APR 27 1954

3. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted and approved a progress report from the subject Subcommittee requesting an extension of the target date for the completion of the project until 22 June 1954. JUN 1 1954

12. Case 53-44 - Revision of ASPR, Section XV, Part 2. A report from the Section XV Subcommittee presenting the subject revision was concurred in by the members for the purpose of securing comments from the Technical Services, Bureau and Commands. Departmental comments are to be received by 1 August 1954. JUN 22 1954

9. Case 53-44 - Revision of Section XV. The members noted the designation of Mr. G. A. Connatser, AFADD, as the Air Force member of the subject Subcommittee, vice Mr. A. B. Thomas, AFADD. AUG 24 1954

7. Case 52-37 - Section VII - Clauses, Price Revision Clauses.  
Case 53-64 - Tax Credits - Downward Contract Price Revision.  
Case 53-44 - Revision of Section XV. The members noted the designation of Mr. P. M. Southwell, AFMPE, as the Air Force member of the subject Subcommittee, vice Lt. Col. H. T. Critchlow, AFMPE. AUG 24 1954

2. Case 53-44 - Revision of Section XV - Cost Principles. The Committee considered the issues raised in the Section XV Subcommittee report as follows:

- a. Should costs of profit sharing plans be allowable to the extent recommended by the proponents in the report?
- b. Should costs of stock bonus plans be allowable?
- c. Should costs of independent research and development be allowable?

Both a. and b. were answered in the affirmative. Major discussion was directed toward the fact that although such plans are generally called "profit sharing" they are in reality additional compensation measured by earnings. Accordingly, in drafting this principle, the latter fact will be emphasized.

With respect to issue c., it was determined that "related research" should be allowable if "applicable to the product or product line." As to "general research," a division was made as follows:

- (1) Allowable if (i) the contractor's business is predominantly commercial (i.e., 75% or more), (ii) such costs are also allocated to commercial work, (iii) the contractor submits reports of work accomplished and, (iv) the costs are reasonable.
- (2) If the contractor's business is not predominantly commercial, specific provision must be made in the contract for such costs. It was recommended that negotiations for such costs be handled centrally in each Department so that greater uniformity can be attained.

The Air Force reserved the right to review both areas when a final Subcommittee report is issued. OCT 26 1954

21. Case 53-44 - Revision of Section IV - Contract Cost Principles. Copies of Parts 1 and 2 of the proposed revision of Section IV, revised by the Subcommittee pursuant to receipt of service comments, were distributed to the members. The members were further advised that Parts 3 and 4 were currently in the process of being reproduced and that copies would be provided the members as soon as they become available. NOV 24 1953

10. Case 53-44 - Revision of Section IV - Contract Cost Principles. Copies of Parts 3 and 4 were distributed to the members. The members were further advised that the Subcommittee report was currently being prepared and that copies would be provided the members as soon as the report became available. DEC 1 1953

11. Case 53-44 - Revision of Section IV - Contract Cost Principles. The members noted a report of the subject Subcommittee presenting Parts 1, 2, 3 and 4 of the subject revision together with the comments of the Office of the Deputy Comptroller for Accounting Policy, OSD, outlining the Comptroller's position with respect to the issues unresolved by the Subcommittee. Consideration of the reports were deferred pending the development of Departmental positions with respect to the reports. DEC 8 1953

6. Case 53-44 - Revision of Section IV. Mr. Warren Webster, Jr., Director of Procurement and Production Policies, OASD (S&L), informed the members that following discussions with the Assistant Secretary of Defense (Comptroller) it was agreed that the ASPR Committee should immediately undertake:

- a. Recasting of the Subcommittee report in the format of the present Section IV. *Part*
- b. Deletion of the pricing and accounting data.
- c. The revision to be applicable only to cost-type contracts.
- d. Upon completion of the cost principles for cost-type contracts, to immediately undertake the development of cost principles applicable for fixed-price contracts.

The task was assigned to the Section IV Subcommittee for accomplishment.

The members were further advised that the Subcommittee effort, after approval by the ASPR Committee, would be coordinated with the Office of the Assistant Secretary of Defense (Comptroller) prior to industrial coordination.

In undertaking this task the Subcommittee was to consider all existing departmental papers that would have a bearing on this subject and endeavor to complete their assignment on an expedited basis. FEB 9 1954

19. Case 53-44 - Proposed Revision of Section IV - Contract Cost Principles. The Chairman read to the members a memorandum, signed by the Staff Director, Purchasing and Contracting Policies Division, for the Director of Procurement and Production Policies, with respect to the agreement reached by a panel of DOD and Services representatives with the Assistant Secretary of Defense (Comptroller) concerning the format of the revision to Section IV. A copy of the memorandum is attached as Inclosure 1. MAR 9 1954

11. Case 53-44 - Revision of Section IV - Contract Cost Principles. The members expressed concern over the apparent delayed progress of the subject Subcommittee and discussed the feasibility of more frequent meetings of that Subcommittee in an effort to effect a timely resolution of this problem. It was agreed that the subject Subcommittee would present a report for consideration at the 4/27/54 meeting setting forth the accomplishments to date toward revision of Section IV. It was further agreed that an invitation would be extended to the members of the subject Subcommittee to be present at the 4/27/54 meeting for a discussion of their progress in this development. APR 20 1954



5. Case 53-44 - Revision of Section XV - Contract Cost Principles. During a brief discussion of the proposed revision of paragraph 15-313.15, developed by the Tax Subcommittee, the Committee members were advised that the Section XV Subcommittee had considered the proposal in their revision of Section XV. The members were further advised that the Section XV Subcommittee accepted the report in substance and that it would be included, with minor modification, in the final draft of Part 3, Section IV. The members agreed that in an effort to conserve time the Subcommittee report will be forwarded by the Committee members, upon receipt, to the Technical Services, Bureaus and Commands for comments, with a suspense date of three weeks from date of receipt of the report. The forwarding of the Subcommittee report in this manner does not imply Committee approval. **AUG 11 1953**

12. Case 53-44 - Revision of Section XV. The members noted Parts 1, 2 and 3 of the proposed revision, copies of which were forwarded to the departments for comments by the technical services, bureaus and commands on 8/26/53. **SEP 1 1953**

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a report from the Patents Subcommittee commenting on the proposed revision dated 16 September 1953, together with a supplemental report from the Patents Subcommittee dated 17 September 1953, which the staff had referred to the Section XV Subcommittee for consideration. **SEP 22 1953**

17. Case 53-44 - Revision of Section XV.

- a. The members noted Part 4 of Section XV, developed by the Subcommittee, which was forwarded to the Departments for comments, with a request that comments be presented by 21 October 1953.
- b. Consideration of the issue as to whether Section XV should be incorporated in price redetermination clauses on a mandatory or optional basis was deferred until the next meeting at the request of the Office of the Deputy Comptroller for Accounting Policy, OSD. **OCT 6 1953**

4. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether Section XV should provide for the specific inclusion by contract provision of the revised cost principles in contracts containing price redetermination or incentive provisions. It was determined to reserve action on this issue until the Subcommittee could present specific contract language for consideration. The tentative conclusion was that the clause should read that the principles were applicable to such contracts as a guide only. The changes and the clause are to be presented for consideration at the 10/20/53 meeting. **OCT 13 1953**

3. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether the revised Section XV would be incorporated by reference in all price redetermination and incentive clauses and, if so, what type of contract provision was appropriate for the purpose. After a prolonged discussion with the members of the Subcommittee and a representative of the Deputy Comptroller's Office the Committee determined that there be no reference to Section XV in these clauses. The Comptroller's representative did not concur with the Committee's decision. The proposed wording to accomplish this concept was approved by the members. A special Group was designated to set forth in writing, substantiation on the position for non-inclusion and the representative of the Deputy Comptroller's Office will provide his written views for mandatory inclusion. These documents will ultimately be forwarded to a higher level for resolution of the issue.

Members designated to the Special ASPR Group to develop the Committee's position were:

Army - Brig. Gen. W. R. Allen, GS G-4  
Navy - Mr. G. C. Bernerman, ONM (Chairman)  
AF - Col. Thos. W. Ryan, AFMPE

**OCT 20 1953**

The ASPR Committee would undertake, on an accelerated basis, the further development of the revision, using as a starting point

b. Part 3.

MB - Mr. H. H. Gallup (Chairman)  
Army - (Proc.) Lt. Col. J. M. Railing, GS G-4  
(Accounting) (To be designated)  
Navy - Mr. E. T. Cook, S&A  
Mr. A. C. Sawallisch, ONM  
AF - Lt. Col. H. T. Critchlow, AFMPE  
OSD - (To be designated) JUN 9 1953

**JUN 9 1953**

Subsequent to the meeting Mr. R. M. Kee was designated Army Accounting representative to the subject Subcommittee. JUN 16 1953

2. Case 53-44 - Revision of Section XV. The members noted a report from the Subcommittee, which presented the Subcommittee's recommendations on Parts 1 and 2 of the Deputy Comptroller's proposal to revise Section XV. The members were informed that further discussions between the Special Assistant to the Secretary (Admiral Ring) and the Deputy Comptroller for Accounting Policy were being scheduled to review the Committee treatment of this Revision.

JUL 7 1953

13. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a memorandum from the Chairman of the Section XV Subcommittee which recommended that paragraph 15-313.15 be referred to the Tax Subcommittee for consideration on an accelerated basis, and that the staff had referred the problem to the Tax Subcommittee for consideration and recommendation, with a request that a report be provided by 8/14/53. JUN 28 1953



# NEWS RELEASE

PLEASE NOTE DATE



DEPARTMENT OF DEFENSE  
OFFICE OF PUBLIC INFORMATION  
Washington 25, D.C.

IMMEDIATE RELEASE

MAY 12, 1955

NO. 456-55  
LI 5-6700 Ext. 53201  
53176

## DEPRECIATION PARAGRAPH INCLUDED IN ASPR COST INTERPRETATION

*Carl*  
*53-44*

A cost interpretation paragraph, relating to depreciation, will be included as part of Section XV of the Armed Services Procurement Regulation, effective June 1, 1955, Thomas P. Pike, Assistant Secretary of Defense (Supply and Logistics), announced today.

The new paragraph, 15-602, which will be published by the Government Printing Office as Revision of the ASPR, follows:

### "15-602 - Depreciation.

"15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

"15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation", as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

"15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

E N D

15 August 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Section XV - 15-204.2(aa)  
Training and Educational Costs

Pursuant to Item 3 of ASPR minutes of 7 August 1956, the  
Editing Committee has edited the subject material, as set forth  
in Tab A.

C. W. Wilkinson  
Lt. Colonel, JAGC  
Chairman  
Army Member

John Green  
Navy Member  
(absent)

John W. Perry  
Air Force Member

Incl: Tab A

DEPARTMENT OF THE NAVY  
OFFICE OF NAVAL MATERIAL  
WASHINGTON 25, D. C.

M36/ACS:11

2 August 1956

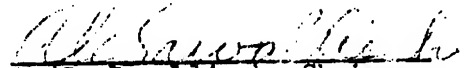
MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb)  
Training and Educational Expense

Ref: (a) Report of Subcommittee of 12 July 1956

Encl: (1) Proposed language for ASPR 15-204.2(bb)

1. Reference (a) was considered by the ASPR Committee at their meeting on 31 July 1956. A number of recommendations were made which the subcommittee has endeavored to incorporate in enclosure (1).
2. It is probable that subparagraph e of enclosure (1) will also be included in ASPR 15-204.3 - Unallowable Costs and referenced back to ASPR 15-204.2(bb).
3. The enclosure has not been coordinated with the Office of the Secretary of Defense, Office of Manpower Supply, it being the understanding of the Subcommittee that the ASPR Committee would do so.

  
A. C. Sawallisch, Chairman

Committee Members

Mr. Paul H. Southwell, AFMPP  
Mr. Thos. B. Worsley, Army Ord.  
Mr. W. L. Latta, AFAUD  
Mr. James Ruttenberg, NAVCOMPT(CAD)

15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. The costs of part-time technical, engineering and scientific education, related to the job requirements of bona fide employees, at an under-graduate or post-graduate college level are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes after regular working hours.

c. The costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education related to the job requirements of bona fide employees, on a full-time basis at a post-graduate college level for a total period not to exceed one school year, are allowable. In unusual cases where required by military technology, the period may be extended.

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent that such facilities are used under programs falling within a or b, above.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered as contributions and will be treated as provided under ASPR 15-204.3(c).

Enclosure 1

5. Case 53-44 - Section XV, 15-204.2(aa) - Training and Educational Costs. A report from the Editing Subcommittee, dated 15 August 1956, presenting an edited version of the subject material was approved by the Committee with the following minor modifications:

15-204.2(aa) (2) (v) was revised to delete (A) and (B). The semicolon appearing after (A) was changed to a comma and the word "and" was added at the end of the paragraph. With these modifications the paragraph was redesignated as (iv) and the existing paragraph (iv) as paragraph (v), deleting the word "and" at the end thereof.

The members were advised that immediately following ASFR approval coordination of the paragraph would be undertaken by the Staff by memorandum with the ASD (M&P).

The subject of industry coordination was discussed, with the Committee recommending that industry be afforded an opportunity to comment, inasmuch as the paragraph covering Training and Educational Costs was marked "Reserved" in the draft of Section XV which was forwarded to industry. Notwithstanding this recommendation, the Committee concurred that formal solicitation of industry comments on this paragraph was a matter for decision by the Staff. AUG 29 1956

11. Case 53-44 - Revision of Part 2, Section XV. The OSD member reported that the Materiel Secretaries have recommended the allowance of costs for help-wanted advertising and advertising in technical publications and that this, plus any remaining problems, is being resolved by higher echelons. A further report will be made by 6 Mar 57.

6 Feb 57

3. Case 53-44 - Revision of Section XV, Part 2. It was noted that this problem is being considered at higher echelons and that a further report will be made on 5 Jun 57.

APR 28 1957

Case 53-44 - Revision of Section XV, Part 2. The members concurred in the request of the Staff for an extension of the reporting date to 3 Jul 57.

(5 Jun 57)

Case 53-44 - Revision of Section XV, Part 2. A report on the status of the revision of Section XV, Part 2, was deferred to the 17 Jul 57 meeting.

(10 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that action on this case had been suspended pending the outcome of the effort on the single set of cost principles. Copies of the letter of transmittal accompanying the single set, from the Secretary of Defense to the three Departments, were distributed to the members only. A further report will be given at the 14 Aug 57 meeting.

(17 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that further action on Part 2, Section XV, is not contemplated, as a result of current efforts to publish the comprehensive set of cost principles. The Army Legal member suggested that in view of this information the case be closed. The members concurred in this suggestion and, accordingly, the case is closed.

(14 Aug 57)

3. Case 53-44 Section XV - 15-204.2(bb) - Training and Educational Expenses. The Committee considered a report from the Special Subcommittee, dated 21 August 1956, covering the subject paragraph on training and educational expenses. After considerable discussion the Subcommittee report was modified as quoted below:

"15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs of salaries or wages of trainees during regular working hours are allowable.

b. The costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes during working hours not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours.

c. The costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education on a full-time basis at a post-graduate (but not under-graduate) college level related to the job requirements of bona fide employees for a total period not to exceed one school year, are allowable. In unusual cases where required by military technology, the period may be extended.

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent set forth in (k) above, (e) above and (t) above, respectively.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered as contributions and will be treated as provided under ASPR 15-204.3(c)."

The report was referred to the Editing Subcommittee with the request that an edited version be presented for consideration by 21 August 1956. In the interim the ASPR members will clear the proposed paragraph within their respective Departments and the Staff will undertake coordination with the Assistant Secretary of Defense (Manpower and Personnel). The Committee further determined that if the paragraph was cleared in time, it would be inserted in Section XV for issuance concurrently with the printing of that section. The Chairman further advised the members that the proposed paragraph probably would be presented to the Procurement and Production Industry Advisory Committee to secure an industrial reaction.

In conjunction with the above paragraph, the subject of the allowability of management and executive training costs was discussed and deferred without action to modify the above paragraph.

In approving the above paragraph the Committee considered and rejected the concept of allowing full-time salaries for bona fide employees on a full-time basis at post-graduate college levels.

9. Case 53-44 - Revision of Section XV - Part 2 - Paragraph 15-204.2(n) - Overtime. The Navy legal member called the Committee's attention to a discrepancy existing in the present revision of Section XV in paragraph 15-204.2(n) with respect to overtime, extra-pay shift and multi-shift premiums. To correct this situation the Committee approved the substitution of the words "otherwise approved" for the words "otherwise authorized" appearing in the fourth line of the paragraph. The Committee further approved the deletion of the words "without prior approval" in next to the last line of the paragraph. AUG 7 1956

3. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Navy legal member called the Committee's attention to a further change required in the subject paragraph in view of the changes approved at the 8/7/56 meeting in paragraph 15-204.2(n) to remove an inconsistency between the two paragraphs. To correct this situation the Committee approved the substitution of the word "approval" for the word "authorization" as it appeared in the second and third sentences of subparagraph (b) of the ASFR minutes of 17 July 1956. AUG 14 1956

12. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. The Committee considered a report from the Section XV Subcommittee, dated 30 July 1956, presented in response to a report from the Tax Subcommittee dated 21 June 1956. In considering the Section XV Subcommittee's report with respect to the three questions raised by the ASFR Committee and the Subcommittee's suggested treatment thereof, the Committee disagreed with the Subcommittee's clarification of the first question and reinstated the previous language under subparagraph (1) to read:

"...and which are paid or accrued in accordance with generally accepted accounting principles are allowable,  
..."

The Committee further revised the two sentences following (2) (ii) to read:

"Reasonable cost of any such action undertaken by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to assure timely direction after prompt request therefor, are also allowable."

The Committee concurred in the Subcommittee report concerning the other questions. These include retaining the present language of subparagraph (2) (ii) without change and the addition of a proviso provision to subparagraph (3) as follows:

"... , provided any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

As revised above the Committee approved the changes for inclusion in Section XV. AUG 14 1956

3. Case 53-144 . Section XV - 15-204.2(bb) - Training and Educational Expenses  
A report dated 12 July 1956 from the Special Subcommittee established to consider the subject problem was discussed at length. The discussion touched upon many facets of the problem, such as whether the proposed allowance of training and educational expenses was in keeping with the National policy or merely a question of the "cost of doing business" in the present economy. It was pointed out that many commercial concerns have established programs for the advancement of their engineering and scientific employees by supporting their education in after-hour classes and, to some extent, even on a full-time basis at graduate schools. It was further pointed out that it is the President's policy to promote training, particularly higher training, starting at the high school level. In addition, the members were advised that the Hoover Committee had recommended Governmental support and training to encourage Governmental career employees. To some extent, the Army and Navy are now using this practice for certain selected employees.

The Committee then undertook consideration of the proposed paragraph contained in Inclosure 4 of the Subcommittee report, in conjunction with the other inclosures. The paragraph was approved, as modified by the Committee, subject to editing as follows:

"15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks, when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level related to the job requirements of the employee as follows:

1. Tuition, fees, training materials and textbooks.
2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level, related to the job requirements of the employee, for a total period not to exceed one school year. In unusual cases where required by **military technology, the period may be extended.**

d. **The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable."**

The Committee also noted that it may be necessary to include an appropriate cross-reference to subparagraph (d) of 15-204.2(bb) in the listing of items of unallowable costs.

A further question was raised with respect to the treatment of costs occasioned where contractors established schools at their own locations on the premise that such costs ought to be covered by the above paragraph. As these costs would involve both facilities and faculty expenses, the question of how such costs would be treated was returned to the Subcommittee to draft appropriate coverage for inclusion in the above paragraph 15-204.2(bb). The Subcommittee was requested to provide a report for consideration by 7 August 1956. JUL 31 1956



11. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Committee considered a report from the Editing Subcommittee, dated 21 June 1956, presenting an edited version of the subject material. The Committee modified the second and third sentences of subparagraph (b) to read as follows:

..... "On cost-type contracts, and to the extent required by the contracting officer on redeterminable and incentive fixed-price contracts, however, an authorization from the Government for the use of overtime, extra-pay shifts and multi-shifts must be obtained to sustain the charge of any premium labor costs to the contract. Such authorization should generally be obtained prior to the use of overtime, extra-pay shifts and multi-shifts." .....

In the last sentence of subparagraph (b) the word "required" was substituted for the word "desired."

In the title of paragraph 12-102 the word "Shifts" was changed to read "Shift" in the phrase "Extra-Pay Shifts."

As modified, the revised paragraph 12-102 was approved for printing concurrently with the printing of Section XV. JUL 17 1956

4. Case 53-44 - Revision of Section XV - Contract Cost Principles - Part I. The Committee considered a report, dated 6 July 1956, from the Editing Subcommittee presenting an edited version of the revision of Part I, Section XV. After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. A further suggestion was made that when the revised Part I was published a change was required in paragraph 15-502(a) to replace the comma with a period and delete all material following the comma. The Committee approved the recommendation. JUL 24 1956

1. The minutes of the 7/24/56 meeting were approved with the following modification:

Item 4. Case 53-44 - Revision of Section XV - Contract Cost Principles Part I.

The case number was revised to read 56-29, and the second sentence was revised to read: "After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Air Force member of the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. JUL 31 1956

7. Case 53-44 - Revision of Part 2, Section XV. Report dated 21 June 1956 from the Tax Subcommittee, recommending certain changes in proposed paragraph 15-204.2(y) of the latest draft of Part 2, Section XV, was discussed. It was determined that the paragraph should not include a reference to "taxes of foreign governments" since the award of cost-reimbursement type contracts by local procuring activities to foreign contractors occurred so infrequently that this matter should be covered on a case-by-case basis when awards are made to foreign contractors. In the revised draft of the paragraph submitted by the Tax Subcommittee in subparagraph (1) the question was raised as to whether defense would reimburse a contractor for taxes incurred. In subparagraph (2) (ii) the question was raised as to the soundness of the statement, and in subparagraph (3) it was indicated that the last sentence should be a "proviso" sentence. The entire report was referred to the Part 2, Section XV Subcommittee for review, in coordination with the Tax Subcommittee, if necessary, and the request made that a report be submitted within 30 days. JUL 3 1956

13. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). An Editing Subcommittee report dated 21 June 1956 submitted an edited version of a revised ASFR paragraph 12-202. The ASFR Committee discussed the details of this draft and made the following three observations with respect to paragraph (b):

- a. In line 3 it was suggested that there be added after the word "contractor," the following:

", and the contractor shall not be entitled to a price adjustment therefor,";

- b. In subparagraph (ii) discussion concerned having the subparagraph commence "To the extent required by the contract"; and

- c. Having the third from the last sentence read:

"Such authorization shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts."

It may also be necessary to delete the "s" from the phrase "extra-pay shifts" wherever it appears in the entire clause.

The Committee members desired to look into this matter further and, accordingly, the item will be discussed again at next week's meeting.

JUL 3 1956

15. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Secretary was requested to include this item on the agenda for the next meeting. In the interim the members will look further into the matter.

JUL 10 1956

4. Case 53-44 - Revision of Section XV, Part 2. The Chairman announced that the Material Secretaries Council had decided that the subject of profit sharing, contributions and donations, and general research costs would receive the same treatment under the revised Part 2 as in the existing Section XV. It was determined that there was no objection to using the revised language concerning general research costs developed by the Editing Subcommittee; however, with respect to the negotiation criteria set forth in the edited version under general research costs, it was agreed that they would not appear in Part 2 but would be placed appropriately in Part 1 of Section XV. APR 17 1956

9. Case 53-44 - Revision of Section XV, Part 1. The Committee considered a memorandum from the Chairman recommending that when Section XV, Part 2, is revised that certain changes, as set forth, be made simultaneously in Part 1. It was determined that these recommendations be referred to the Editing Subcommittee with the further request that the Editing Subcommittee review the suggested placement of proposed paragraph 15-103. With respect to this latter point, it was agreed that the Committee had previously directed the placing of this material in Part 1, but in reconsidering, the question was presented as to whether it should not more properly be placed in Part 5. The Editing Subcommittee was requested to report within two weeks. MAY 1 1956

11. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. A report from the Editing Subcommittee, dated 26 April 1956, containing a final edited draft of subject was distributed to the members. In addition, a revised draft of a document containing the major unresolved issues with industry were also made available to the members. Both of these documents will be attached to an agenda item for the Material Secretaries Council in the very near future and the members were requested to give their concurrence to the documents to the Chairman by 4 May 1956. MAY 1 1956

12. Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). A revision of the subject paragraph, developed by the Staff to conform with the proposed Section XV treatment of overtime, extra-pay shift and multi-shift work, was considered by the members and referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to present a report for consideration by 29 May 1956. MAY 8 1956

5. Case 53-44 - Revision of Part 2, Section XV. A representative of the Tax Subcommittee reported that the Subcommittee had noted several areas not explicitly covered by paragraph 15-204.2(y), entitled "Taxes," which could result in issues with contractors. In view of the current status of Section XV, the Committee requested the Tax Subcommittee to present their written comments in order that these potential deficiencies could be considered. JUN 5 1956

12. Case 56-29 - Revision of Section XV, Part 1.  
Case 53-44 - Revision of ASFR 12-202 to Conform to Proposed ASFR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). The Chairman raised the question of when reports would be received from the Editing Subcommittee with respect to the subject problems. The Navy legal member advised that a report from the Editing Subcommittee on the two subject problems would be presented within one week. JUN 5 1956

1. The minutes of the 6/5/56 meeting were approved with the following modification:

Item 5. Case 53-44 - Revision of Part 2, Section XV. The last sentence was revised to add the words "for subsequent revision of Section XV." JUN 12 1956

Part 5 - Subjects Affecting Cost Which May Require Special Consideration.

"Part 5 - Subjects Affecting Cost Which May Require Special Consideration.

15-500 Scope of Part. This Part enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in Part 3, or Part 4, of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations."

Part 6 - Cost Interpretations.

"Part 6 - Cost Interpretations  
Delete balance of this Part and substitute therefor the word 'RESERVED'."

Part 7 - Facilities Contracts.

"15-700 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for the acquisition of industrial facilities to which the Government takes title under the contract. This Part also applies to clauses in any other cost-reimbursement type contracts or cost-reimbursement type subcontracts thereunder, which clauses provide for the acquisition of industrial facilities to which the Government takes title.

15-701 Applicability. Pending publication of the principles and standards to be incorporated in this Part, Parts 2, 3, or 4 shall be used to the extent appropriate in accordance with Departmental procedures."

The Committee was further advised that a change similar to the change made in Part 4 (15-403 (q)) would also have to be made in Part 3, 15-304 (g). The Committee concurred in such a change.

NOTE: Subsequent to the meeting the following change was received from the Editing Subcommittee for Part 3 - Research Contracts with Nonprofit Institutions:

"15-304 Examples of Items of Allowable Costs. . . .

(g) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2(q) and group health, accident and life insurance plans (but see paragraph 15-305(k))."

Action to develop a clean draft of Part 2, incorporating the changes approved to date, was deferred until after the Material Secretaries consider the existing three issues.

APR 10 1956

15-204.2 (1) Insurance and Indemnification. (Page 9). This subpara. graph was revised to read as follows:

"15-204.2 (j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise."

15-204.2 (n) (1) and (6) Material Costs. Pages 11 and 12). Were revised to read:

"15-204.2 (n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intramodal insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material; consideration will be given to reasonable overruns, spoilage, and defective work (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work).

\* \* \* \* \*

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower, unless factors other than price warrant allowance on the basis of the cost to the transferor; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the ~~same or substantially similar items, whichever is the~~ lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer."

The Committee further considered proposed revisions of existing Parts of Section XV, together with a new proposed Part 7 covering Facilities Contracts, presented by the Editing Subcommittee, the revisions to be issued simultaneously with the issuance of the revised Part 2. The Committee approved the following revisions:

Part 4 - Construction Contracts.

"15-403 Examples of Items of Allowable Costs. . . . .

(q) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2 (q) and group health, accident and life insurance plans (but see paragraph 15-404 (b), (d), and (m))."

CONT'D  
NEXT  
PAGE

contractor's products, or other relevant circumstances.

Individual categories of indirect cost are discussed in ASFR 15-203.2 through 15-203.5."

15-200. The Committee approved a revision of the TITLE and the "Scope of Part" as quoted below:

"Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors other than such contracts and subcontracts to which Parts 3, 4, or 7 apply."

15-204.2 (f) (2) Depreciation. (Page 7). This subparagraph was revised to read as quoted below:

"\* \* \* \* \*

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed:

- (i) upon the property cost basis used by the contractor for Federal income tax purposes (See Section 167 of the Internal Revenue Code of 1954); or
- (ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income tax; and in either case
- (iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations."

The Air Force withdrew its former request for consideration of additional language to be added to subparagraph (iii) which would, in effect, have provided that the depreciation allowable under a contract would not exceed the depreciation authorized under the Internal Revenue Code. This action was taken on the premise that the disadvantages of holding contract files open for an indeterminate period of time until final determinations of depreciation had been made by tax authorities or by the Courts outweighed the advantages sought by the additional language.

APR 10 1956

CONT'D  
NEXT  
PAGE

4. Case 53-44 - Revision of Section XV. Consideration of the special areas subject to revision or review at the Special Meeting held 4/6/56 was undertaken in the following order:

15-204.2 (p) Patents. (Page 12). The last line of the edited draft, dated 29 March 1956, was revised to delete the words "by the Government" and substitute therefor the words "where title is conveyed to the Government."

15-204.2 (o) Overtime. (Page 12). The members were advised that the OASD (M&P) had no objections to revising ASFR paragraph 12-102 to be consistent with this paragraph. Accordingly, the Staff will prepare a revision of 12-102 for consideration.

15-203.5 General and Administrative Costs. (Pages 4 and 5). This paragraph was revised to read as follows:

"15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs) is a method which generally produces equitable results. Other methods acceptable where the circumstances are appropriate include allocation on the basis of:

- (i) processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct materials);
- (ii) factory input costs (processing costs plus direct material);
- (iii) cost of goods completed;
- (iv) cost of sales; and
- (v) sales (where no more satisfactory method is available)."

15-203.1 (b) General. (Page 3). This subparagraph was revised to read as follows:

"15-203.1 (b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, provide uniformity of treatment for like cost elements, be applied consistently, and produce equitable results. A previously acceptable method shall be subject to reconsideration when:

- (i) Any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or
- (ii) Any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the inventories, the volume of sales, the volume of production, manufacturing processes, the

APR 10 1956  
CONT'D  
NEXT  
PAGE

Page 21. 15-204.2 (aa) (1). The third word reading "contractor's" was deleted.

15-204.2 (bb). This paragraph was reserved. A Special Subcommittee was established to consider this problem as a special case, presenting a revised coverage on the subject of training costs. In taking this action the Special Subcommittee was requested to give consideration to inclusion of a reference on page 26 when their efforts are completed. The Subcommittee was further requested to coordinate their efforts with the OSD Office of Manpower Supply. Members designated to the Subcommittee were:

Army - To be designated

Navy - Mr. A. C. Sawallisch, ONM (Chairman)

Mr. James Ruttenberg, OCN

AF - Mr. P. M. Southwell, AFMPP

Mr. W. L. Latta, AFAUD

The Subcommittee was requested to present a report for consideration by 7 May 1956.

Page 22. Approved.

Page 23. Approved.

Page 24. 15-204.3 (i). The Committee deleted the reference in parentheses at the end of this paragraph. In taking this action, there was general agreement to specifying the period and amount in part 1 when rewritten, with an appropriate cross-reference.

Page 25. Approved.

Page 26. 15-204.3 (2) (xi). The words "special tooling costs" were deleted and the word "taxes" substituted therefor.

15-204.2 (2) (xii), Training Costs, was deleted in its entirety.

15-204.2 (2) (xiii), Travel Costs, was renumbered to (xii).

The Navy legal member called the Committee's attention to the Editing Subcommittee's report of 27 February 1956, in paragraph 4 of which the Subcommittee covered the subject of side agreements. It is understood that this matter had been the subject of discussion by the Procurement Secretaries in the spring of 1955.

With the above action, further consideration of this subject was deferred until the next meeting to be held 4/10/56.

APR 6 1956



As revised the paragraph was referred to the Editing Subcommittee, with the request that the edited language be presented by the next regular meeting (10 April 1956).

15-204.2 (n) (6). The semicolon following the phrase "whichever is lower" was changed to a comma and the following language added:

"unless factors other than price warrant allowance on the basis of the cost to the transferor;"

Page 12. 15-204.2 (n) (6). The word "either" appearing before (i) was deleted. The period at the end of the paragraph was changed to a comma and the following language was added:

"whichever is lower, unless factors other than price warrant allowance on the basis of the cost to the transferor."

15-204.2 (n). The Staff will undertake action to determine whether a revision to paragraph 12-102 may be made in order that paragraph 12-102 be consistent with this paragraph.

15-204.2 (p). The Staff was requested to clear the need with the Patents Advisor of the inclusion of the words "or on behalf of" in the last line.

Page 13. Approved.

Page 14. 15-204.2 (q) (3) (iv). The Committee agreed to the inclusion of a note in the Minutes that under this paragraph the parties can agree to (A) or (B) for the individual periods under the contract.

15-204.2 (q) (3) (iv) (A). The second word "all" was deleted.

Page 15. 15-204.2 (q) (3) (iv) (B) (II). The words "or gains" were inserted after the word "credits" in the sixth from the last line.

Page 16. Approved.

Page 17. 15-204.2 (u). The words "such factors as" were inserted between the words "of" and "the" in the second line.

15-204.2 (v) (2). This paragraph was reserved.

Page 18. Approved, subject to deletion of brackets in 15-204.2 (v) (3).

Page 19. Approved.

Page 20. Approved.

APR 6 1956

CONT'D  
NEXT  
PAGE

Page 4. Delete a comma in paragraph 15-203.2.

Paragraph 15-203.5. The Air Force member recommended that everything after the first two sentences of this paragraph be deleted. After considerable discussion this recommendation was rejected. However, subparagraph (i) was deleted in its entirety. Subparagraph (ii) was referred to the Audit members of the Section XV Subcommittee for clarification, with the request that the revised language be presented for consideration at the next regular meeting (10 April 1956). Final decision will be made on this paragraph after revised (ii) is reviewed.

Page 5. ~~Approved.~~ ~~barrier saw danger of being~~ ~~subcommittee~~

Page 6. Approved, reserving subparagraphs (d) and (e) of 15-204.2.

Page 7. 15-204.2 (f) (2) (i) (ii) (iii). These subparagraphs were revised to read as follows:

"(i) is computed upon the property cost basis used by the contractor for Federal income tax purposes (See Section 167 of the Internal Revenue Code of 1954); or

(ii) in the case of nonprofit or tax exempt organizations, upon a cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income taxes, and

(iii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954. In no event, however, shall a greater amount for depreciation be allowed than is authorized by the Internal Revenue Code."

The Navy member objected to the addition of the underscored language pending further study.

As revised, this paragraph was referred to the Editing Subcommittee for editing, with the request that the edited paragraph be presented for consideration by the next regular meeting (10 April 1956).

Page 8. Approved.

Page 9. Was approved, subject to further editing of the last sentence of paragraph 15-204.2 (j) (1), which was referred to the Editing Subcommittee with the request that the edited language be presented by the next regular meeting (10 April 1956).

Page 10. Approved, subject to the deletion of a comma in 15-204.2 (k) (1) (2).

Page 11. 15-204.2 (n) (1). This subparagraph was modified to add the following words in parentheses:

"(for correction or defective work see the clause of the contract relating to 'Inspection and Correction of Defective Work')." APR 6 1956

CONT'D  
NEXT  
PAGE

53-44

Revision of Section XV,  
Contract Cost Principles

Editing

JAN 31 1956

The members were advised  
a report on this problem  
would be presented by  
14 February 1956.

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. A report of the Chairman of the Editing Subcommittee pointing up certain areas requiring resolution prior to final editing was noted and further consideration deferred until the next meeting. In the interim the Editing Subcommittee was requested to meet with the Section XV Subcommittee in an effort to resolve as many of the areas as possible and to report on their accomplishments at the 6 March 1956 meeting. FEB 28 1956

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Chairman advised the members that the Editing Subcommittee was still studying the problem which had arisen with respect to "Pension Plans" and that it was contemplated a report would be presented in the near future. When the report is received the members will be contacted to determine the need of a special meeting to consider the problem. MAR 6 1956

5. Case 53-44 - Section XV - Contract Cost Principles. The Committee determined to hold a special meeting Friday, 16 March 1956, at 1100 hours, in room 2216, Main Navy Building, to consider the report of the Editing Subcommittee on this problem. MAR 13 1956

11. Case 53-44 - Revision of Section XV - Part 2. The Chairman of the Editing Subcommittee advised the members of the progress to date of the joint efforts of the Editing Subcommittee and the Section XV Subcommittee in completing the editing of Part 2 of Section X. In view of the Committee's action it was determined that no special meeting would be held Friday, 23 March 1956, to consider this problem but that the report, if available, would be considered at the next regular meeting. MAR 20 1956

The Army member expressed an inability to ascertain what the phrase "Commercial Type Accounting Systems" encompassed. In this connection he wished it made a matter of record that if the section is to be meaningful a definition of this phrase should be included.

13. Case 53-44 - Revision of Section XV, Part 2. The Chairman of the Editing Subcommittee advised that revised copies of this part jointly being considered by the Section XV Subcommittee and the Editing Subcommittee would be available by Friday, 30 March 1956. In this connection, the Chairman expressed a desire that the revised report could be considered at the next regular meeting to be held 3 April 1956.

The Chairman further advised the members that instructions to the Staff with respect to the three issues covering

Profit Sharing,  
Contribution and Donation, and  
General Research

MAR 27 1956

were to be accorded the same treatment now provided in the current Section XV.

4. Case 53-44 - Revision of Part 2, Section XV. A Staff proposal presenting a revision of paragraph 15-204.15, Insurance and Indemnification, was considered, approved after minor modification and referred to the Editing Subcommittee as shown below:

"15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Department concerned.

(iv) Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For example, see ASPR 7-203.22). Except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self insurance program or otherwise), are not allowable."

In further considering paragraph 15-204.34(b)(1) the Committee questioned the advisability of providing for an allocation of cost to all general research work of the contractor if the concept of providing for an allowance of the cost is specifically covered in the contract. The Committee determined that as long as this concept is retained no provision for an allocation was required. Accordingly, subparagraph (A), reading as follows, was deleted:

"(A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research."

With this action corrected copies of Part 2 of Section XV were distributed to the legal members for their respective members of the Editing Subcommittee in order that editing of the draft could be undertaken. The Editing Subcommittee was requested to provide a report for consideration by 13 January 1956.

DEC 13 1955

15-204.2.1 The seventh sentence was revised to read:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing for retrospective accounting and any necessary adjustment to the pension plan cost incurred under the contract."

With this modification the paragraph was approved.

15-204.8 Contributions and Donations. Copies of the Air Force minority position with respect to this paragraph, which was isolated as an issue at the 11/22/55 meeting, were distributed to the members for presentation to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue.

As modified by the ASPR Committee the Subcommittee report was referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to provide a report for consideration by 10 January 1956. To facilitate editing, the Staff will provide the members of the Editing Subcommittee with a clean draft of the report.

DEC 6 1955

2. Case 53-44 - Revision of Part 2, Section XV. In approving the minutes of the 12/6/55 meeting the Air Force requested that the last sentence under paragraph 15-204.35, Royalties and Other Costs for Use of Patents, be revised to express the concept in two sentences rather than one. Accordingly, this sentence was rephrased as follows:

"Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. Charges for the use of Patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract."

DEC 13 1955

15-203.3 presented by the Subcommittee was approved. A Staff proposal to revise this paragraph was rejected.

15-204.34b(1) Copies of a revision to this paragraph starting with the third sentence, developed by the Air Force member, were distributed to the members. The paragraph was then discussed at length. As a compromise the Committee revised (1) under paragraph b to read as follows and tentatively approved the paragraph, subject to editing, the Navy and Staff positions being reserved:

(A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.

The Government shall have no right to use such a patent or invention

- a. Scope, nature and quality of the contractor's independent general research program.
- b. The capability of the contractor in the particular research field.
- c. Benefits which may accrue to the Government.
- d. Comparison of size and cost of contractor's previous years' research programs.
- e. The proportion of the Government business to the contractor's total business."

In considering the paragraph the Committee also determined that the Government's position versus Industry's position with respect to general research should be presented to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue with industry.

15-204.34b(11) approved.

15-204,340 approved.

15-204.260 The second sentence was revised to read:

"Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal Income Tax purposes in the current taxable year."

With this modification the paragraph was approved.

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NEXT  
PAGE

1. a. The minutes of the 11/22/55 meeting were further modified as follows:

Item 3. Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.24. The paragraph was revised to read:

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as allowable either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

- b. The minutes of the 11/29/55 meeting were approved with the following revisions:

Item 2 - Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.34b(i) was revised to read:

"A proposed subparagraph c. presented by the Staff was considered and rejected. In lieu thereof the Committee suggested the insertion of the following first parenthetical expression in the third sentence of (i) which would read as follows:

"The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"

However, the positions of the Departmental members with respect to this change was reserved." DEC 6 1955

2. Case 53-44 - Division of Part 2, Section XV. Copies of a memorandum from the Subcommittee Chairman presenting revisions of paragraphs 15-204.25, 15-204.29c, 15-204.34d and 15-204.35 were distributed to the members and the following action taken on the revised paragraphs:

~~15-204.25 was revised as follows:~~  
15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

As revised the paragraph was approved, subject to editing.

15-204.29c reading as follows was approved:

"15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government are unallowable. The costs of legal, accounting and consulting services and related expenses incurred in connection with patent infringement litigation are unallowable unless otherwise provided in the contract."

15-204.34d reading as follows was approved:

"15-204.34 RESEARCH AND DEVELOPMENT

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

15-204.35 reading as follows was approved:

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent, or a patent has been adjudicated to be invalid, are unallowable unless otherwise provided in the contract."

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DEC 6 1955



2. Case 53-44 - Revision of Part 2, Section IV. The Committee considered certain points in the Subcommittee draft that required action subsequent to that taken by the Committee in its 11/22/55 meeting. These points covered the following subparagraphs:

15-203.5 - The paragraph was revised and approved to read as follows:

"The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year."

15-204.8 - The Air Force member advised that the Air Force position for presentation to the Material Secretaries on this problem would be presented within one week.

15-204.25 -

15-204.34d -

15-204.35 - A memorandum from the Patents Subcommittee setting forth the views of the Patents Subcommittee with respect to these paragraphs was distributed to the members. After a brief discussion the problem was returned to the Section IV Subcommittee for further consideration in conjunction with the Patents representatives of the three Departments. The Section IV Subcommittee was requested to provide an interim report at the next meeting and a final report by 13 December 1955.

15-204.33b - Two alternative proposals to subparagraph b. of this subparagraph were distributed by the Navy member. After discussion the Committee adopted

the proposal quoted below:

otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) borne by the lessor which would have been incurred had the contractor retained legal title to the facilities."

15-204.34b(1) - A proposed subparagraph (c) presented by the Staff was considered and rejected. In lieu thereof the Committee inserted the following first parenthetical expression in the third sentence of (1), which reads as follows:

"The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"

15-204.15f - The Committee determined to place a period after the word "allowable," deleting the words "unless approved by the Department concerned," subject to editing. The Army legal member was requested to present revised phraseology for this paragraph f. for consideration at the next meeting.

15-203.3 - Consideration of this paragraph was deferred until the next meeting in order that the reaction of the Small Business interests could be obtained.

NOV 29 1955

1. The minutes of the 22 November 1955 meeting were approved with the following modifications:

Item 3. Case 53-44 - Revision of Part 2, Section XV. The first sentence was revised to read:

"In considering the Subcommittee report of 1 November 1955, and the undated Army Audit Agency report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted."

The following paragraphs were adopted as presented by the Subcommittee:

15-202.1  
15-202.2  
15-202.3  
15-203  
15-203.1

Subparagraph 15-204.8. The first sentence was revised to read:

"The Air Force member stated that the problem will be particularly difficult in cases involving industries involved primarily in defense work, such as the aircraft industry. In those cases, contributions and donations, for all practical purposes will be made by the Government and not by the contractor, to such beneficiaries and in such amounts as is determined by the contractor. Therefore, the Air Force position is for continuing the disallowance as in the present ASFR."

Subparagraph 15-204.15. The quoted addition to subparagraph "a" was revised to read:

"The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (for example, see ASFR 7-203.22)."

Subparagraph 15-204.18. A parenthetical expression was added at the end of the first sentence, as follows:

"(including the contractor's contributed portion under cost-sharing R&D contracts)."

With this addition the minutes were revised to read:

"The Committee adopted the Subcommittee position as clarified that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts."

15-204.26d. The penultimate word in the quotes was revised to read "reversionary."

15-204.28 - The second sentence of the paragraph on precontract costs was revised to place a period after the word "contract" and to delete the words "and may be limited to a period of time as well as to the type and amount of such costs."

The minutes were revised to read:

"The Committee accepted the draft as modified."

formula approach set forth in the draft but there was also a general feeling that an appropriate method of control be further explored."

NOV 29 1955

- 15-204.27 - The Committee accepted the draft as written.
- 15-204.28 - The Committee accepted the draft as written.
- 15-204.29 - With respect to subparagraph "c," the Committee adopted the position of the Subcommittee that such legal fees are not allowable.
- 15-204.30 - The Committee adopted the position of the Subcommittee that all profits and losses on disposition of plant, equipment or other capital assets be excluded in computing contract costs.
- 15-204.31 - The Committee adopted the Subcommittee position that specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the interests of the Government and the Contractor.
- 15-204.32 - The Committee accepted the draft as written with the exception that the second sentence was revised to read as follows:
- "It further includes the costs of operating an aptitude and educational testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment."
- 15-204.33 - With respect to subparagraph "b," consideration was given to the change recommended by the American Institute of Accountants. Mr. Ruttenberg was requested to draft substitute language for submission to the Editing Subcommittee.
- 15-204.34 - The Committee discussed at length the Subcommittee approach with respect to general research. There was general agreement in the formula approach set forth in the draft but there was also a general feeling that a dollar ceiling be coupled with such approach. Using this as a basic concept, the Staff was requested to develop a proposition for further consideration.
- 15-204.35 - The Committee adopted the position of the Subcommittee that payments of royalties to contractors should be circumscribed by contract provision or otherwise authorized by the Contracting Officer.
- 15-204.36 - The question was presented as to whether at least the protection afforded the Government in proposed ASPR 15-202.1 should not be provided. However, it appeared that the protection sought should be related to the "Inspection of Supplies and Correction of Defects" clause (ASPR 7-203.5c). The Army member recommended that the Editing Subcommittee give consideration to insertion of the word "consumer" after "training" in the phrase "and training personnel in the use,".
- 15-204.37 - The Committee accepted the draft as written.

CONT'D  
NEXT  
PAGE

15-204.22 - The Committee concurred in the recommendation to include "accountants fees" immediately after "attorneys fee" in the second sentence of the paragraph.

15-204.23 - The Committee accepted the draft as written.

15-204.24 - The Committee adopted the Subcommittee position with respect to identification separately of shift premium and overtime. However, the paragraph was changed to read as follows:

"15-204.24 OVERTIME, EXTRA PAY, SHIFT AND MULTI-SHIFT PREMIUMS. This item consists of the premium portion of extra pay and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as government work. See ASFR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost."

15-204.25 - The Committee deferred consideration of this paragraph and the parenthetical expression in 15-204.3d until the next meeting.

15-204.26 - The Committee accepted the draft as written with the exception of the following changes:

15-204.26c - The second sentence was revised to read as follows:

"Such costs may include excess contributions made in previous years to the extent such contributions are claimed and allowed for tax purposes in the current taxable period.

15-204.26d - The next to the last sentence was revised to read as follows:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and refund of any necessary credits."

15-204.26e - This subparagraph was revised to read as follows:

"The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than incurred under approved pension plans will be subject to consideration on an individual case basis."

NOV 22 1955  
CONTY  
NEXT  
PAGE

13. Case 53-44 - Revision of Section XV. The member noted the designation of Maj. J. O. Hunnicutt, Jr., DEP ICG, as Army member of the subject Subcommittee, vice Lt. Col. J. M. Railing, DEP ICG. FEB 1 1955

1. Case 53-44 - Revision of Section XV. Copies of a proposed DOD Instruction, developed by the Office of the CSD Comptroller, to provide guidance with respect to depreciation in keeping with Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness, were distributed. After a brief discussion, the Committee concluded that it should be highly desirable to incorporate the policy in the Regulations if possible, rather than have it published as a DOD Instruction. To achieve this end, the Section XV Subcommittee was requested to develop appropriate coverage of the proposed Instruction in Part 6 of Section XV, or submit recommendations as to other media for publication, including a recommendation with respect to the proper document for use for the other media.

In taking this action the Committee agreed that modification of the depreciation paragraph (15-204.9) to incorporate the principles of the proposed directive should be postponed until after receipt of comments from industry on the proposed Section.

The Subcommittee was requested to provide a report for consideration by 15 March 1955. MAR 1 1955

4. Case 53-44 - Revision of Section XV, ASFR. A report from the Section XV Subcommittee, presenting a proposed depreciation - cost interpretation for inclusion in Part 6 of Section XV, was concurred in in principle, subject to editing. In taking this action the members noted three areas requiring further consideration:

- a. Effective date.
- b. Inclusion of the text of Section 167 of the Internal Revenue Code of 1954, and
- c. Omission of any reference to "true" depreciation.

The above areas were referred to the Editing Subcommittee for consideration in conjunction with editing the proposal. The Staff volunteered to develop a cross-reference to "true" depreciation for consideration by the Editing Subcommittee. The Editing Subcommittee was requested to provide a report for consideration by 29 March 1955. MAR 1 1955

10. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASFR. A report from the Editing Subcommittee, presenting the subject interpretation, was discussed at length. The report was returned for reconsideration. While the Committee did not finally determine its position, the Editing Subcommittee should redevelop the project along the following lines:

- a. Applicability of the interpretation. In the absence of a specific agreement the interpretation applies to all "open" contracts.
- b. With respect to the assets involved. Undertake interpretation, thinking in terms of the description of the assets covered, utilizing therefore the provisions of the statute.

Consider again the desirability of quoting or paraphrasing such of the statute as will render the depreciation cost interpretation generally understandable in itself. APR 5 1955

15-204.38 - The Committee accepted the draft as written with the exception that the Army member recommended that the Editing Subcommittee consider revising the definition of "special tooling" to conform with that currently being proposed by the Section XIII Subcommittee.

15-204.39 - The Committee adopted the Air Force minority position with respect to subparagraph 15-204.39a(3), and that of the Subcommittee on 15-204.39b.

15-204.40 - The Committee adopted the Subcommittee position with respect to the non-allowability of costs incident to exhibitions.

15-204.41 - The Committee accepted the draft as written.

15-204.42 - The Committee accepted the draft as written with the exception that the Army member requested that the Editing Subcommittee consider that line 5 of the second paragraph be revised to read: "\* \* \* provided the contractor follows a consistent procedure which provides for equitable results in this respect."

15-204.43 - The Committee accepted the draft as written.

With respect to the third observation set forth in the first page of the Subcommittee report, the conclusion was reached that Departmental implementing instructions should follow within a reasonable time the publishing of Part 2, Section XV. The Committee also determined that final consideration of Part 2 would be given at a subsequent meeting, but as soon as possible.

UNV 22 1955

6. Case 53-44 - Revision of Section XV. The members noted copies of the comments received from industry on the proposed revision of the subject Section. The Committee Chairman requested the Departmental members to impress upon their respective Subcommittee members the need for expeditious completion of this project. JUL 26 1955

15/ Case 53-44 - Revision of ASPR Section XV. The members noted an interim progress report from the subject Subcommittee, included on the agenda. The Committee extended the time for a final report until 27 October 1955. OCT 4 1955

*see agenda for this date*

3. Case 53-44 - Revision of Part 2, Section XV. Consideration of a report from the Section XV Subcommittee, presenting a revision of Part 2, Section XV, was deferred at the request of the Air Force member until the meeting of 22 November 1955. NOV 8 1955

3/ Case 53-44 - Revision of Part 2, Section XV. In considering the Subcommittee report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted. The action of the Committee resulted in the following:

15-200 - In considering the industry position that a statement be included to the effect that Section XV is not applicable to fixed-price contracts, including those with price redetermination provisions, the question was presented as to whether it was necessary to preclude the application of the principles to certain types of contracts. It was stated that a separate Part for Section XV will be developed to cover facilities contracts. The Committee determined that the "Notes and Filing Instructions" covering the ASPR Change which will include Part 2 should contain a note that the use of the principles is not precluded in connection with facilities contracts pending publication of that Part of Section XV which will cover facilities contracts.

15-201 - The Committee adopted the Subcommittee position that the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs" is only one of the factors affecting allowability of costs and does not take anything away from the contractor.

15-202 - Accepted the draft as written.

15-203.2 - Discussion centered around the parenthetical phrase "(including independent research projects)" as set forth in 15-203.2, the Air Force recommendation with respect thereto, and the relationship of the phrase to 15-204.34c. It was the determination of the Committee that the stated phrase should be deleted and that "(see ASPR 15-204.34c)" should be inserted in lieu thereof. The Committee also determined that the second parenthetical phrase in 15-203.2 "(exclusive of overtime premium)" should be changed to read "(exclusive of overtime, extra pay, and multi-shift premium)".

NOV 22 1955

CONT'D  
NEXT  
PAGE

15-204.10 - The Committee accepted the draft as written.

15-204.11 - The Committee adopted the Subcommittee position that entertainment expense should not be allowed and that there was no conflict between this paragraph and 15-204.10 and 15-204.10.

15-204.12-14 - The Committee accepted the draft as written.

15-204.15 - In accordance with the point expressed by the Army member, the Committee determined that subparagraph "a" should provide some coverage with respect to indemnification. It was decided that proposed subparagraph "g" should be deleted and that such coverage, revised to read as follows, should be inserted at the end of subparagraph "a".

"The cost of indemnification will be allowable only to the extent expressly provided for in the contract (for example, see ASPR 7-203.22)."

It was also determined that subparagraph "c" should be revised to read as follows:

"c. The costs of insurance or any reserve covering the risk of loss or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve."

With these changes, and especially that concerning indemnification, the Editing Subcommittee should review the paragraph with respect to coverage given these cost elements.

15-204.16 - The Committee adopted the Subcommittee position that interest be an unallowable cost.

15-204.17 - The Committee accepted the draft as written.

15-204.18 - The Committee adopted the Subcommittee position that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts.

15-204.19 - The Committee adopted the Subcommittee position that any recognition of cost of deferred maintenance expenses through contract provision is proper.

15-204.20 - The Committee accepted the draft as written.

15-204.21 - The Committee adopted the Subcommittee position that cash discounts not be considered as financial income. The Air Force member withdrew the Air Force minority position concerning subparagraph "b." With respect to subparagraph "d," the Committee concluded the subparagraph should consist of only the first sentence as set forth in the draft. The Committee also adopted the Subcommittee position with respect to the non-allowability of the cost of write-down of inventory value.

NOV 22 1954  
CONT'D  
NEXT  
PAGE



15-203.3 - The Committee discussed the proposition of whether any selling expense is properly allocable to a Government contract. There was no question that selling and distribution expenses as related to sales of the products of a company to commercial customers should not be allowed. The Committee concluded that the paragraph as written should remain, subject to the Staff discussing the proposition with the Small Business Advisor to the Assistant Secretary of Defense (S&L).

15-203.4 - The Committee considered that the listing of ~~illustrative factors to be considered in~~ determining whether a method of distributing general and administrative expenses was helpful and should remain in the paragraph.

15-203.5 - The Committee concurred in the Subcommittee position that there was no inconsistency between this paragraph and 15-203(b). The paragraph was, however, revised to read as follows:

"The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs."

15-204 - The Committee accepted the paragraph as written.

15-204.1 - The Committee adopted the Subcommittee position that the proposed instructions with respect to allowance of costs of advertising were not too restrictive.

15-204.2-5 - The Committee accepted the draft as written on these paragraphs.

15-204.6 - The decision with respect to the DOD position on profit sharing is expected within the near future.

15-204.7 - The Committee accepted the draft as written.

15-204.8 - The Air Force member stated that because experience had demonstrated the difficulty of controlling these expenses it was the position of the Air Force that contributions and donations not be allowable as costs. The Air Force was requested to present its revised position to be used in connection with the presentation of an item for decision by the Material Secretaries and the Assistant Secretary of Defense (S&L).

15-204.9 - With respect to subparagraph "e," the Navy member withdrew the Navy minority position. In the discussion which followed, the Committee determined that the following should be inserted as the third sentence in subparagraph "e":

"The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period."

The Editing Subcommittee may improve upon the verbiage of the concept expressed in the insertion.

CONT'D  
NEXT  
PAGE

5. Case 53-44 Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A report from the Editing Subcommittee was briefly discussed and further consideration deferred until the next meeting to permit the Editing Subcommittee to consider an alternative redraft of paragraph 15-602.1, which is quoted below:

"15-602.1 Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204 (d), 15-205 (b) and 15-205 (c). It is effective with respect to existing and future contracts; provided that, as regards existing contracts this interpretation shall not be applicable in any case where there is an express agreement in writing that a different interpretation shall be applicable." MAY 3 1955

2. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A redraft of the proposed paragraph 15-602.1, Applicability and Effective Date, was distributed to the members. After discussion the redraft was slightly modified and approved. The Committee further modified the last sentence of paragraph 15-602.2. Subject to these modifications, the Committee approved the Cost Interpretation for printing. In taking this action the Committee concurred in the issuance of a Press Release announcing the Cost Interpretation, by the Staff, and in the Departments promulgating the Interpretation within their Departments prior to its publication in the Regulation. The Interpretation, as approved, is quoted below:

"15-602 - Depreciation.

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(c). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to pre-determined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation," as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

MAY 10 1955

1. The minutes of the 12/21/54 meeting were approved with the following

First sentence. Prior to discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information and resolution where appropriate:

- a. Major differences with industry.
- c. Those areas in which the Services are not in accord.

15-204.6 - Compensation for Personal Services.

The Committee reviewed the proposal of the Subcommittee as contained in their report of December 15, 1954 and agreed that the proposed subparagraph (c) should be changed as follows:

15-204.6 (e), (f) and (g).

The Air Force nonacceptance of the principle set forth in these subparagraphs results in classifying this as an issue. (The issue, briefly stated, being whether contractor payments pursuant to Profit Sharing and Stock Bonus Plans determined by profits are merely compensation measured by profits and are allowable for reimbursement, or whether payments pursuant to such plans are distribution of profits and therefore are not reimbursable as costs.) To be resolved by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

~~15-204.9 - Depreciation.~~ The Committee considered comments of the Subcommittee relative to the effect of new revenue legislation (Section 167 of the Internal Revenue Code of 1954) on the existing provisions of Section XV. It was generally agreed that the ASFR provision remain unchanged, that a press release be arranged on the topic for information to the public, and that contemporaneously with the press release, appropriate instructions be promulgated to field audit personnel.

15-204.9 (e) b.

"The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facilities."

15-204.27 (f) - Pension and Retirement Plans.

After considerable discussion of reversion credits and the methods by which arrangements can be made that are equitable to the Government, there was general agreement that the paragraph remain as written, but that the attention of the Assistant Secretary of Defense, OASD (S&L), and the Procurement Secretaries be directed to the difficulty of this issue. It is also to be explained that part of the draft will be issued as an instruction, as it is not appropriate as a cost principle. The Navy member agreed to frame the issue, to be inclusive of mass severance pay, and forward copies thereof to the Army and the Air Force.

15-204.41 - Taxes.

- (a) (1) After the third word "taxes" of the subparagraph add ("including state income taxes.")

NOTE: Underscoring denotes change.

JAN 4 1955

7. Case 53-44 Revision of Section XV. Prior discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information:

- a. Major past differences with industry,
- b. Those areas involving a change from the current ASPR position, and
- c. Those areas in which we are not according to industry the treatment desired by them.

The members then commenced discussion of the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and Other Food Services.  
Principle modified and agreed to.

15-204.6 - Compensation for Personal Services.

The Committee reviewed the proposal of the Subcommittee and agreed that the proposed subparagraph (c) should be changed as follows:

- a. At the end of the introduction to subparagraph c., change the colon to a comma and add the following:

"in addition to those set forth in subparagraph (d) (1), (2), (7), and (g) below:"

- b. Revise subparagraph (iii) to read as follows:

"for allowance purposes, the cost of stock options will be amortized equally over an appropriate period from the date the option is exercised depending upon the terms of the option agreement."

The members accepted the proposal of the Subcommittee to delete the second sentence of 15-204.6 (d) (2).

15-204.6 (e) and (f). The Air Force nonacceptance of the principle set forth in these subparagraphs results in clarifying this as an issue (the issue, briefly stated, being whether contractor costs in Profit Sharing and Stock Bonus Plans are merely compensation measured by profits and are allowable for reimbursement, or whether such plans are distribution of profits) to be resolved by the Assistant Secretary of Defense (S&I) in conjunction with the Procurement Secretaries.

DEC 21 1954

15-204.37 b (1) (iii) - General Research.

15-204.38 - Severance Pay.

15-204.41 - Taxes.

The members further determined to delete from the revision, paragraph 15-204.40 - Strikes and Lockouts - Expenses of.

In addition to the above issues the Subcommittee was requested to clarify the language contained in the following subparagraphs:

15-204.22 - Materials and Supplies.

Subparagraph b - re discounts, and

Subparagraph d - re pricing of materials in stock where replacement cost differs significantly from book cost.

A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954.

The subject of clearing the proposed revision with the Comptroller General's office was discussed. It was concluded that it would be highly desirable to informally present a copy to the GAO at the same time the proposal is referred to industry for comment. NOV 30 1954

DEC 2 1954

A. B. C.

DEC 6 1954

3

1. a. The minutes of the 11/30/54 Regular Meeting, and the Special Meetings held 12/2/54 and 12/6/54, were approved with the following modifications:

- Item 5. Case 53-44 - Revision of Section XV - Contract Cost Principles. The entry 15-204.14 - Profit Sharing, in the second paragraph, was revised to read:

~~"15-204.14 - Profit Sharing (Profit Sharing)"~~

The fourth paragraph was revised to insert a subparagraph e, as follows:

"Subparagraph e - Intercompany or Interdivisional Sales or Transfers," in lieu of subparagraph b.

The fifth paragraph was revised to read as follows:

"A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length, agreed to in principle, and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954."

DEC 4 1954

1. The minutes of the 10/26/54 meeting were approved with the following modifications:

Item 2. Case 53-44 - Revision of Section XV - Cost Principles.  
The last sentence was revised to read:

"The Air Force tentatively approved the principles for the purpose of going forward but reserved the right to review both areas when a final Subcommittee report is issued."

(Underscoring denotes change). NOV 2 1954

8. Case 53-44 - Revision of Section XV, Contract Cost Principles. The Air Force member presented the problem of the allowability for reimbursement of contract costs under cost-reimbursement type contracts and as to the recognition in price under fixed-price contracts of depreciation on plant and equipment computed in accordance with the Internal Revenue Act of 1954. The members recognized the issue, but indicated that coverage had been considered by the Section XV Subcommittee in developing Part II of Section XV. Members will consider this Part at the 11/30/54 meeting. NOV 17 1954

5. Case 53-44 - Revision of Section XV - Contract Cost Principles. Consideration of a report from the Subcommittee, presenting the latest draft of Part 2, Section XV, revised in the light of comments received from the military departments and guidance from the Committee, began with the discussion of the purpose of considering the report. It was agreed that this review would highlight two types of issues for resolution prior to forwarding the revision to industry for comment. These are:

- a. Issues in which the Departmental positions are unknown and which may be resolved by the Committee at a subsequent meeting, and
- b. Issues where the Departmental positions are known which will require resolution by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

The members undertook consideration of the Subcommittee report on a page by page basis. Issues for further consideration appeared in the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and other Food Services -

15-204.6 f - Stock Bonus Plans.

15-204.8 - Contributions and Donations.

15-204.9 - Depreciation.

15-204.14 - Profit Sharing.

15-204.16 e - Insurance - Officers, Partners, or Proprietors.

15-204.17 - Interest and Other Financial Expenses.

15-204.27 f - Pension and Retirement Plans. (In connection with this issue, the Navy member urged that consideration be given to the deletion of pension reversion credits and mass severance pay from the cost principles, presenting the proposal of the coverage of these subjects to industry in a separate paper, stating that both these items were deleted on the premise that one offsets the other. However, if industry insists on one, the Government will insist on the inclusion of both.)

2. C 53-44 - Revision of Section XV - Contract Cost Principles. The Sect. IV Subcommittee was present and submitted a written and oral report on the activities of the Subcommittee to date. Several features of the Section XV revision were discussed. It was agreed that greater emphasis should be placed on the revision and the Subcommittee will meet two days a week to expedite completion. The target date of 1 June 1954 was established for completion of the Subcommittee's work. APR 27 1954

3. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted and approved a progress report from the subject Subcommittee requesting an extension of the target date for the completion of the project until 22 June 1954. JUN 1 1954

12. Case 53-44 - Revision of ASPR, Section XV, Part 2. A report from the Section XV Subcommittee presenting the subject revision was concurred in by the members for the purpose of securing comments from the Technical Services, Bureau and Commands. Departmental comments are to be received by 1 August 1954. JUN 22 1954

9. Case 53-44 - Revision of Section XV. The members noted the designation of Mr. G. A. Connatser, AFADD, as the Air Force member of the subject Subcommittee, vice Mr. A. B. Thomas, AFADD. AUG 24 1954

7. Case 52-37 - Section VII - Clauses, Price Revision Clauses.  
Case 53-64 - Tax Credits - Downward Contract Price Revision.  
Case 53-44 - Revision of Section XV. The members noted the designation of Mr. P. M. Southwell, AFMPE, as the Air Force member of the subject Subcommittee, vice Lt. Col. H. T. Critchlow, AFMPE. AUG 24 1954

2. Case 53-44 - Revision of Section XV - Cost Principles. The Committee considered the issues raised in the Section XV Subcommittee report as follows:

- a. Should costs of profit sharing plans be allowable to the extent recommended by the proponents in the report?
- b. Should costs of stock bonus plans be allowable?
- c. Should costs of independent research and development be allowable?

Both a. and b. were answered in the affirmative. Major discussion was directed toward the fact that although such plans are generally called "profit sharing" they are in reality additional compensation measured by earnings. Accordingly, in drafting this principle, the latter fact will be emphasized.

With respect to issue c., it was determined that "related research" should be allowable if "applicable to the product or product line." As to "general research," a division was made as follows:

- (1) Allowable if (i) the contractor's business is predominantly commercial (i.e., 75% or more), (ii) such costs are also allocated to commercial work, (iii) the contractor submits reports of work accomplished and, (iv) the costs are reasonable.
- (2) If the contractor's business is not predominantly commercial, specific provision must be made in the contract for such costs. It was recommended that negotiations for such costs be handled centrally in each Department so that greater uniformity can be attained.

The Air Force reserved the right to review both areas when a final Subcommittee report is issued. OCT 26 1954



21. Case 53-44 - Revision of Section IV - Contract Cost Principles. Copies of Parts 1 and 2 of the proposed revision of Section IV, revised by the Subcommittee pursuant to receipt of service comments, were distributed to the members. The members were further advised that Parts 3 and 4 were currently in the process of being reproduced and that copies would be provided the members as soon as they become available. NOV 24 1953

10. Case 53-44 - Revision of Section IV - Contract Cost Principles. Copies of Parts 3 and 4 were distributed to the members. The members were further advised that the Subcommittee report was currently being prepared and that copies would be provided the members as soon as the report became available. DEC 1 1953

11. Case 53-44 - Revision of Section IV - Contract Cost Principles. The members noted a report of the subject Subcommittee presenting Parts 1, 2, 3 and 4 of the subject revision together with the comments of the Office of the Deputy Comptroller for Accounting Policy, OSD, outlining the Comptroller's position with respect to the issues unresolved by the Subcommittee. Consideration of the reports were deferred pending the development of Departmental positions with respect to the reports. DEC 8 1953

6. Case 53-44 - Revision of Section IV. Mr. Warren Webster, Jr., Director of Procurement and Production Policies, OASD (S&L), informed the members that following discussions with the Assistant Secretary of Defense (Comptroller) it was agreed that the ASPR Committee should immediately undertake:

- a. Recasting of the Subcommittee report in the format of the present Section IV. *Part*
- b. Deletion of the pricing and accounting data.
- c. The revision to be applicable only to cost-type contracts.
- d. Upon completion of the cost principles for cost-type contracts, to immediately undertake the development of cost principles applicable for fixed-price contracts.

The task was assigned to the Section IV Subcommittee for accomplishment.

The members were further advised that the Subcommittee effort, after approval by the ASPR Committee, would be coordinated with the Office of the Assistant Secretary of Defense (Comptroller) prior to industrial coordination.

In undertaking this task the Subcommittee was to consider all existing departmental papers that would have a bearing on this subject and endeavor to complete their assignment on an expedited basis. FEB 9 1954

19. Case 53-44 - Proposed Revision of Section IV - Contract Cost Principles. The Chairman read to the members a memorandum, signed by the Staff Director, Purchasing and Contracting Policies Division, for the Director of Procurement and Production Policies, with respect to the agreement reached by a panel of DOD and Services representatives with the Assistant Secretary of Defense (Comptroller) concerning the format of the revision to Section IV. A copy of the memorandum is attached as Inclosure 1. MAR 9 1954

11. Case 53-44 - Revision of Section IV - Contract Cost Principles. The members expressed concern over the apparent delayed progress of the subject Subcommittee and discussed the feasibility of more frequent meetings of that Subcommittee in an effort to effect a timely resolution of this problem. It was agreed that the subject Subcommittee would present a report for consideration at the 4/27/54 meeting setting forth the accomplishments to date toward revision of Section IV. It was further agreed that an invitation would be extended to the members of the subject Subcommittee to be present at the 4/27/54 meeting for a discussion of their progress in this development. APR 20 1954



5. Case 53-44 - Revision of Section XV - Contract Cost Principles. During a brief discussion of the proposed revision of paragraph 15-313.15, developed by the Tax Subcommittee, the Committee members were advised that the Section XV Subcommittee had considered the proposal in their revision of Section XV. The members were further advised that the Section XV Subcommittee accepted the report in substance and that it would be included, with minor modification, in the final draft of Part 3, Section IV. The members agreed that in an effort to conserve time the Subcommittee report will be forwarded by the Committee members, upon receipt, to the Technical Services, Bureaus and Commands for comments, with a suspense date of three weeks from date of receipt of the report. The forwarding of the Subcommittee report in this manner does not imply Committee approval. **AUG 11 1953**

12. Case 53-44 - Revision of Section XV. The members noted Parts 1, 2 and 3 of the proposed revision, copies of which were forwarded to the departments for comments by the technical services, bureaus and commands on 8/26/53. **SEP 1 1953**

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a report from the Patents Subcommittee commenting on the proposed revision dated 16 September 1953, together with a supplemental report from the Patents Subcommittee dated 17 September 1953, which the staff had referred to the Section XV Subcommittee for consideration. **SEP 22 1953**

17. Case 53-44 - Revision of Section XV.

- a. The members noted Part 4 of Section XV, developed by the Subcommittee, which was forwarded to the Departments for comments, with a request that comments be presented by 21 October 1953.
- b. Consideration of the issue as to whether Section XV should be incorporated in price redetermination clauses on a mandatory or optional basis was deferred until the next meeting at the request of the Office of the Deputy Comptroller for Accounting Policy, OSD. **OCT 6 1953**

4. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether Section XV should provide for the specific inclusion by contract provision of the revised cost principles in contracts containing price redetermination or incentive provisions. It was determined to reserve action on this issue until the Subcommittee could present specific contract language for consideration. The tentative conclusion was that the clause should read that the principles were applicable to such contracts as a guide only. The changes and the clause are to be presented for consideration at the 10/20/53 meeting. **OCT 13 1953**

3. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether the revised Section XV would be incorporated by reference in all price redetermination and incentive clauses and, if so, what type of contract provision was appropriate for the purpose. After a prolonged discussion with the members of the Subcommittee and a representative of the Deputy Comptroller's Office the Committee determined that there be no reference to Section XV in these clauses. The Comptroller's representative did not concur with the Committee's decision. The proposed wording to accomplish this concept was approved by the members. A special Group was designated to set forth in writing, substantiation on the position for non-inclusion and the representative of the Deputy Comptroller's Office will provide his written views for mandatory inclusion. These documents will ultimately be forwarded to a higher level for resolution of the issue.

Members designated to the Special ASPR Group to develop the Committee's position were:

Army - Brig. Gen. W. R. Allen, GS G-4  
Navy - Mr. G. C. Bernerman, ONM (Chairman)  
AF - Col. Thos. W. Ryan, AFMPE

**OCT 20 1953**

19. Case 53-14 - Revision of Section XV - Contract and Principles. The members were informed by the Munitions Board member that pursuant to conversations between Adm. Ring and Mr. Bordner, agreement was reached on the following method of going forward with the further development of a revised Section XV:

The ASPR Committee would undertake, on an accelerated basis, the further development of the revision, using as a starting point

Assistant Comptroller for Accounting Policy, OSD. The Committee agreed that the Subcommittee's initial consideration should be with respect to the basic concepts of the proposal, including the approach for use in fixed-price contracts. It was further agreed that consideration of the Deputy Comptroller's proposal would be divided in the following order:

- a. Parts 1 and 2, and  
b. Part 3.

The members designated to the Subcommittee to undertake the study were:

MB - Mr. H. H. Gallup (Chairman)  
Army - (Proc.) Lt. Col. J. M. Railing, GS G-4  
(Accounting) (To be designated)  
Navy - Mr. E. T. Cook, S&A  
Mr. A. C. Sawallisch, ONM  
AF - Lt. Col. H. T. Critchlow, AFMPE  
OSD - (To be designated) JUN 9 1953

**JUN 9 1953**

16. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Chairman advised the members that Mr. Howard Wright and Mr. K. K. Kilgore had been designated OSD representatives to the subject Subcommittee.

Subsequent to the meeting Mr. R. M. Kee was designated Army Accounting representative to the subject Subcommittee. JUN 16 1953

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted the designation of Mr. A. B. Thomas, AFAUD, as an additional Air Force member of the subject Subcommittee. JUN 30 1953

2. Case 53-44 - Revision of Section XV. The members noted a report from the Subcommittee, which presented the Subcommittee's recommendations on Parts 1 and 2 of the Deputy Comptroller's proposal to revise Section XV. The members were informed that further discussions between the Special Assistant to the Secretary (Admiral Ring) and the Deputy Comptroller for Accounting Policy were being scheduled to review the Committee treatment of this Revision.

JUL 7 1953

13. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a memorandum from the Chairman of the Section XV Subcommittee which recommended that paragraph 15-313.15 be referred to the Tax Subcommittee for consideration on an accelerated basis, and that the staff had referred the problem to the Tax Subcommittee for consideration and recommendation, with a request that a report be provided by 8/14/53. *JUL 28 1953*

# NEWS RELEASE

PLEASE NOTE DATE



DEPARTMENT OF DEFENSE  
OFFICE OF PUBLIC INFORMATION  
Washington 25, D. C.

IMMEDIATE RELEASE

MAY 12, 1955

NO. 456-55  
LI 5-6700 Ext. 53201  
53176

## DEPRECIATION PARAGRAPH INCLUDED IN ASPR COST INTERPRETATION

*Carl*  
*53-44*

A cost interpretation paragraph, relating to depreciation, will be included as part of Section XV of the Armed Services Procurement Regulation, effective June 1, 1955, Thomas P. Pike, Assistant Secretary of Defense (Supply and Logistics), announced today.

The new paragraph, 15-602, which will be published by the Government Printing Office as Revision of the ASPR, follows:

### "15-602 - Depreciation.

"15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

"15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation", as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

"15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

E N D

15 August 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Section XV - 15-204.2(aa)  
Training and Educational Costs

Pursuant to Item 3 of ASPR minutes of 7 August 1956, the  
Editing Committee has edited the subject material, as set forth  
in Tab A.

C. W. Wilkinson  
Lt. Colonel, JAGC  
Chairman  
Army Member

John Green  
Navy Member  
(absent)

John W. Perry  
Air Force Member

Incl: Tab A

DEPARTMENT OF THE NAVY  
OFFICE OF NAVAL MATERIAL  
WASHINGTON 25, D. C.

M36/ACS:11

2 August 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb)  
Training and Educational Expense

Ref: (a) Report of Subcommittee of 12 July 1956

Encl: (1) Proposed language for ASPR 15-204.2(bb)

1. Reference (a) was considered by the ASPR Committee at their meeting on 31 July 1956. A number of recommendations were made which the subcommittee has endeavored to incorporate in enclosure (1).
2. It is probable that subparagraph e of enclosure (1) will also be included in ASPR 15-204.3 - Unallowable Costs and referenced back to ASPR 15-204.2(bb).
3. The enclosure has not been coordinated with the Office of the Secretary of Defense, Office of Manpower Supply, it being the understanding of the Subcommittee that the ASPR Committee would do so.

  
A. C. Sawallisch, Chairman

Committee Members

Mr. Paul H. Southwell, AFMPP  
Mr. Thos. B. Worsley, Army Ord.  
Mr. W. L. Latta, AFAUD  
Mr. James Ruttenberg, NAVCOMPT(CAD)

15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. The costs of part-time technical, engineering and scientific education, related to the job requirements of bona fide employees, at an under-graduate or post-graduate college level are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes after regular working hours.

c. The costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education related to the job requirements of bona fide employees, on a full-time basis at a post-graduate college level for a total period not to exceed one school year, are allowable. In unusual cases where required by military technology, the period may be extended.

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent that such facilities are used under programs falling within a or b, above.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered as contributions and will be treated as provided under ASPR 15-204.3(c).

Enclosure 1

DEPARTMENT OF THE NAVY  
OFFICE OF NAVAL MATERIAL  
WASHINGTON 25, D. C.

M36/ACS:11

12 July 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

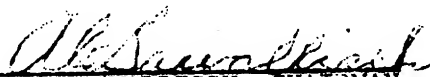
- Encl: (1) Proposed draft as agreed upon by Mr. W. L. Latta, AFAUD; Mr. James Ruttenberg, Navy CAD, and A. C. Sawallisch, Navy ONM.
- (2) Discussions in support of enclosure (1).
- (3) Proposed draft of Memorandum to the Secretary of Defense or other competent authority for ruling on the disputed portion.
- (4) Proposed draft as agreed upon by Mr. Paul Southwell, AFMPP; Mr. Thomas B. Worsley, Army Ord, and Mr. Albert Kay, Office of ASTSECDEF(MANPOWER & RESERVE.)
- (5) Discussion in support of enclosure (4).
- (6) Proposed Section ASPR 15-204.2(bb) presented by Mr. Ken Borgen, Navy Industrial Manpower, and discussion in support thereof.

1. The Special Subcommittee appointed by the ASPR Committee on 6 April 1956 to consider the problem of extent to which Training and Educational Costs should be allowed is unable to come to complete agreement and the diverse opinions are being presented to the ASPR Committee for resolution.

2. Agreement has been reached, with some differences in language, to allow the costs of (i) vocational training, whether it be "in-plant" or in vocational or trade schools, i.e., the training of welders, electricians, machine operators, etc., and (ii) training of a short term nature which is necessary to meet an immediate, clearly defined need of the contractor in connection with a specific engineering, production or administrative problem. The latter type of training may be in the plants or laboratories of other contractors or of the Government, or in technical institutions as well as in trade or vocational schools.

3. The essential difference concerns the allowability of costs for college and post-graduate courses in the sciences and engineering in a curriculum leading to higher academic degrees rather than to meet an immediate need of the contractor. Enclosures (1), (2) and (3) present the position of the group which is of the opinion that there is no existing Department of Defense policy which permits the acceptance of such costs and are of the further opinion that policy making in this field, being of a National interest, should be undertaken by those in the Government charged with respect to education and training rather than

by purchasing and accounting personnel. Enclosures (4) and (5) present the position of the group which would allow such costs, together with standards and limitations for allowability thereof. Enclosure (6) is a draft of proposed ASPR Section 15-204.2(bb) submitted by Mr. Ken Borgen, Navy Industrial Manpower.

  
A. C. SAWALLISCH, CHAIRMAN

Committee Members

Mr. W. L. Latta, AFAUD  
Mr. James Ruttenberg, Navy CAD  
Mr. Paul M. Southwell, AFMPP  
Mr. Thos. B. Worsley, Army Ord.

Coordinated with:

Mr. Albert Kay, OASD(MP&R)  
Mr. Ken Borgen, Navy Industrial Manpower



15-204.2(bb) Training and Educational Expense.

(a) Vocational training is that type of training, generally of a short term nature, which is necessary to meet an immediate, clearly defined need of the contractor, such as training to overcome a particular engineering, production, or administrative problem. It may be carried on in plant, in trade or vocational schools or in technical institutions. The costs of preparing and carrying out vocational training courses may include the salaries or wages of the training director and staff; training material and text books when the program is controlled by the contractor, and the salaries or wages of trainees for time spent during regular working hours. Costs may also include the salaries or wages of trainees for time spent during regular working hours, travel, tuition, laboratory fees, training materials and text books when the training is carried out in vocational, trade or technical training institutions. Such costs are allowable when reasonable and properly allocated to all work of the contractor.

(b) The costs of educational and general training programs of a type aimed primarily at increasing the general educational or skill level of trainees, rather than solving immediate specific problems are not allowable. This includes the general area of long range management, executive or professional training programs and scholarships, fellowships or other emoluments to employees or others.

Enclosure (1)

## DISCUSSIONS IN SUPPORT OF ENCLOSURE (1)

1. It is the opinion of the undersigned that under existing policies there should be separate treatments for expenses in connection with vocational training; i.e., training of supervisors, machine operators, welders, electricians, etc. and the education in technological fields of engineers, scientists, etc.
2. It has long been the practice of industry to support the expense of vocational training. This practice had its recognized acceptance in the guild and apprentice systems which have for years been a part of union agreements. An acceleration of this practice was instituted during World War II when the shortage of skilled workmen and foremen became acute and the Armed Services established a policy of accepting a pro-rata portion of such costs in connection with Defense contracting. It is the opinion of the undersigned that that practice should be continued and that it be made clear that training costs in vocational or technical training schools also be acceptable in order to give identical support in those instances where smallfirms find it impractical to conduct "in-plant" vocational or technical training.
3. While the undersigned do not question the need for development of more and better engineering and scientific personnel, they do not consider that the policy heretofore followed in regard to vocational training expenses should be automatically applied to educational costs in the professional and academic fields without a delineation of policy by competent authority. If one uses current newspaper, magazine and company publication stories as basis for judgement, these costs are going to be substantial and their acceptance in cost-type contracting would make their acceptance in redeterminable and incentive type contracting almost mandatory.
4. A proposed paragraph ASPR 15-204.2(bb) is attached as enclosure (1) which would allow the cost of the type training discussed in paragraph 2 above and not allow the costs of the type discussed in paragraph 3 above. It is in connection with the type of costs discussed in paragraph 3 above that the Committee cannot come to agreement. Enclosure (3) is a draft of a memorandum which the ASPR Committee may wish to submit to competent authority for a statement of policy.

Enclosure (2)

MEMORANDUM FOR THE SECRETARY OF DEFENSE

Subj: Employee Educational Costs Incurred by Defense Contractors

1. The stepped-up production requirements during World War II created a demand for skilled craftsmen such as welders, electricians, etc. that could be met only by extensive training courses, most of which were conducted on an "in-plant" basis. A policy to accept such training costs in connection with Defense contracts was established and has been continued.
2. The current demand by industry for more and more engineers and scientists to produce the highly technical military items now in use and to carry out the extensive research and development programs is well known. A recent study by the Phoenix, Arizona, Chamber of Commerce stated that this years graduating class would fall short by 50,000 men. In an effort to meet this demand numerous educational programs, both graduate and undergraduate are being instituted and given financial support by industry and our procuring activities are faced with the problem of how much, if any, of the costs of such programs should be allowed in the costing or pricing of Defense contracts. The following excerpts are taken from an article on the subject in the May 26 "Business Week."

"Many companies have set up programs to send a few of their more highly talented engineers to graduate schools full-time. Others are planning to send their engineers to special graduate courses a few hours a week, on company time. Some are trying to persuade graduate school facilities to set up off-campus schools for their engineers by offering to build facilities and pay instructors."

Convair Division of General Dynamics Corporation is working hard to persuade the University of California regents to set up a graduate school at San Diego and "guarantees students for the center, has promised aid in funds, equipment, and pay for the faculty. Unofficial estimates put the cost of building the center at close to \$4 million."

General Electric is just establishing a program which "will send 20 engineers to Syracuse University and 40 to Rensselaer Polytechnic Institute to work for their doctorates. It will pay the cost of their tuition and books, put them on the company pay roll and they will get seniority and credit for any benefits that might accrue to them."

Syracuse University is operating three branches; one at Griff's Air Force Base at Rome, New York, for Air Force engineers and General Electric engineers from a nearby plant; the second and third at Endicott and Poughkeepsie, New York, for I.B.M. engineers. The Air Force and IBM supply classrooms on their own properties and the two companies and the Air Force foot the bills for faculty salaries, travel and overhead.

Enclosure (3)

Rensselaer Polytechnic is operating a graduate school near Hartford, Connecticut, in facilities provided by United Aircraft Corporation. 80% of the students are United Aircraft Corporation employees and the United Aircraft Corporation is underwriting the experiment for five years. The cost to the company is about \$1,000 a year per student.

A recent Raytheon Manufacturing Company plant publication announced availability to their science and engineering employees of educational grants at M.I.T. and Harvard. Grants will cover full tuition, fees, book allowance and a monthly salary of \$240 while in residence at the school. Undergraduate students are also considered if working for a science or engineering degree and plan to join the company upon graduation.

3. Obviously, the costs to industry for support of these programs will become significant, particularly in the aviation, guided missile, electronic, nuclear physics and other highly technical fields where the shortage of engineers and scientists is greatest, and it is in those fields where the military departments are the principal customers. Assuming, therefore, that such costs were accepted, even on an allocated basis, substantial dollars appropriated for the purchase of Defense material would be spent in support of educational programs.

4. It is well known that the present National policy is to encourage industry, colleges, universities, and foundations to give support to any program designed to increase the quantity and quality of engineering and scientific personnel. It has not been noted, however, that any Government financial support has been made available for the furtherance of such programs. A number of questions therefore present themselves in connection with the possible acceptance of such costs in our contracting.

a. If it is determined that the National interest requires a Government subsidy for engineering and scientific education, should the subsidy be administered through private contractors, thereby working to their individual competitive advantage, including a profit on their participation in the program, or should it be administered directly by the Government.

b. If participation is to be through the allowance of the cost in Defense contracting should such support be limited to (i) specific fields and, if so, which fields; (ii) which types of cost should be allowable, i.e., tuition, laboratory fees, salaries paid to instructors, text books, compensation of students while in attendance, cost of scholarships, etc; (iii) should Defense participation be limited to a specified ratio of total contract costs?

5. Procurement and audit policies and procedures in this area are greatly in need. It is my opinion, however, that some basic policy which could be prescribed from answers to the question proposed above must first be established. Since this is an area coming within the purview of your office, I will greatly appreciate an expression from you as to the policy we should pursue.

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level as follows:

1. Tuition, fees, training materials and textbooks.
2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level for a total period not to exceed one school year. In unusual cases where required by military technology, the period may be extended.

d. The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable.7\*

\* This paragraph could be transferred to part of Section XV covering unallowable costs.

## Discussion in Support of Enclosure (4)

The undersigned representatives of Army and Air Force join in the following staff report and recommendations. These are concurred in on a staff basis by the representative of the Office of the Assistant Secretary of Defense (MP&R).

It is the opinion of the undersigned that the ASPR Committee desires a recommendation of policy regarding allowance of the expenses for training technical, engineering and scientific personnel as well as "vocational training," i.e., training of machinists, welders, electricians, etc. The undersigned feel that the ASPR Subcommittee on Training Costs was assigned the task of developing and proposing a policy on a staff basis, and was not expected to side-step the issue by requesting higher authority itself to do the ground-work toward establishing said policy. This is made amply clear in "Instructions to and Duties of ASPR Subcommittees," dated 30 August 1955.

It seems to the undersigned that the group presenting Enclosures (1), (2), and (3) base their thinking on the unrealistic position that the training of welders is more important than the training of scientific and engineering personnel. We believe this position is untenable from the standpoint of assuring the delivery of high quality end-items on a timely basis. The national need for a substantial increase in quality and quantity of scientific personnel is too well known to require elaboration. The President and other principal officials of the Executive Branch have expressed concern over the problem as a key factor in maintaining technological supremacy. Objective measures of industry's needs are reflected in the classified sections of the daily newspapers and in industry's frantic efforts to recruit the graduates of engineering schools.

In the face of these shortages, industry has in the last few years fostered college and post-graduate level training of their own employees as the most immediate and direct way of meeting their production problems, and the demand for products of ever increasing quality and complexity. This is particularly true in military applications of nucleonics, aeronautics and electronics.

As a matter of general principle, it seems to us that costs incurred in such a training program are valid costs of production which will result in better performance on military contracts. The proposed policy set forth in Enclosure (4) is designed in best interests of the Government, with due consideration of fairness and equity to industry. It does not allow all educational and training costs at the college and post-graduate training level. It takes due account of commercial practice in today's situation. At the same time, it limits and defines the allowability of such costs and requires the contractor to bear his own share thereof.

There appears to be agreement between the group presenting Enclosures (1), (2), and (3) and group presenting Enclosures (4) and (5) regarding allowability of costs of non-collegiate training.

The major point at issue is the allowability of costs of college and post-graduate level scientific and engineering training. Paragraphs b and c of Enclosure (4) place limits upon the allowability of such training, whether it be part-time or full-time. Paragraph b defines the types of expenses allowable and the amount of part-time training for which an employee may be compensated. Essentially, it allows for costs of tuition, fees, training materials and textbooks, because the most common practice is for education after paid working hours. Where circumstances do not permit education during paid working hours, regular employee compensation is also allowable not in excess of 156 hours per year. This is the approximate equivalent of one 3-hour course per week.

Paragraph c of Enclosure (4) deals with scientific and engineering education on a full-time basis. It recognizes that such arrangements are occasionally necessary, but prescribes reasonable limits of allowability. It limits reimbursability to bona fide employee; to training in scientific and engineering areas; to post-graduate training alone; and total reimbursement to one school year unless required in unusual cases by military technology. Most important, it limits Government payments to the educational expense alone, (i.e., to tuition, fees, etc.), leaving the contractor to incur the cost of compensation. Since the Government's costs in these very special instances will be on the order of a pro-rated part of \$1,000 per year, while the contractor's share for compensation is likely to be at least of an order of \$5,000 per year (typical salary of an inexperienced engineer), it is felt that contractors will not incur such costs unless there is some positive benefit.

In general, it is felt that the distinction made in Enclosure (1) and (2) between long range and immediate needs is a fictitious one. The need for more and better scientific and engineering personnel - and the educational programs designed to meet such needs - is in a real sense immediate. It is just as immediate and certainly more important than the need for training welders, from the standpoint of obtaining the complex military equipment needed in today's situation. Actually, the government is in many cases allowing costs of college and post-graduate training, but not on a uniform basis and certainly with no clearly defined limitations and standards.

The undersigned therefore recommend the adoption of the policy set forth in Enclosure (4) for incorporation in ASPR 15-204.2 (bb), "Training and Educational Expenses."

/s/ Thomas B. Worsley  
Thomas B. Worsley, Army

/s/ Paul M. Southwell  
Paul M. Southwell, Air Force  
Procurement Member

/s/ Albert Kay  
Albert Kay, OASD (MP&R)

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, allowable costs may include salaries or wages of trainees during regular working hours.

b. Certain part-time technical, engineering and scientific training costs of a college level are allowable in cases where the training is required for contract performance and is directly related to the job requirements of the employee as follows:

- (1) Tuition, fees, training materials and textbooks.
- (2) Employee compensation is allowable during regular working hours for instruction not in excess of a total of 156 hours per year in cases where circumstances do not permit training after paid working hours.

c. The costs of general educational programs of a college level, including scholarships and fellowships, and the costs of training and education of other than bona fide employees are not allowable.

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The above appears to me to be in line with industry practice, reasonable, equitable, and to provide incentive to contractors for the economical use of Government funds in that rigid limitations are established for payment of costs of training of engineering and scientific personnel in terms of relation to contract performance.

/s/ Tom Corrigan

Enclosure (6)



OGC/GWM:ag  
6 July 1956

**MEMORANDUM FOR THE ASPR COMMITTEE**

**Subj: ASPR Case 53-44 -- Revision of Section XV, Contract Cost Principles**

1. The editing and reproduction of Part 1 of Section XV have been completed and this edited Part is attached hereto.
2. In editing this Part, the Editing Subcommittee considered it preferable to place the material set forth in proposed ASPR 15-102.2 in Part 1 rather than add it to Part 5 which would become unnecessary to retain when Parts 3, 4, and 7 are developed on the same bases as the proposed new Part 2.
3. The edited Part 2 of Section XV, dated 20 April 1956, was furnished to you with memorandum of 26 April 1956 and was subsequently corrected as indicated in the memorandum of May 7, 1956 to the Secretary of the ASPR Committee.
4. The Editing Subcommittee recommends that the attached Part 1 be released for publication simultaneously with Part 2.

Charles W. Wilkinson  
Lt. Colonel, SS JAG  
Army Member

George W. Markey, Jr.  
Navy Member  
Chairman

John W. Perry  
Air Force Member

Encl.

## SECTION XV

### CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section sets forth principles and standards for the determination and allowance of costs in connection with the performance of cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder.

#### PART 1 - GENERAL

15-101 Applicability. Subject to ASPR 15-102, the provisions of Part 2, Part 3, Part 4, or Part 7 of this Section (whichever Part is applicable) shall be followed in connection with all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder); however, when deemed by the Head of a Procuring Activity concerned to be more suitable for a particular contract, Part 2 may be followed in place of Parts 3, 4, or 7 (and see ASPR, Section III, Part 7, as to negotiated overhead rates). The term "cost-reimbursement type contract," as used throughout this Section, includes cost contracts, cost-sharing contracts, cost-plus-a-fixed-fee contracts, cost-plus-incentive-fee contracts, and the cost-reimbursement portion of time-and-materials or other contracts (see ASPR 3-404 and 3-405.1).

#### 15-102 Contract Provisions.

15-102.1 General. Part 2, Part 3, Part 4, or Part 7 of this Section (whichever is applicable) shall be made a part of every contract of the type referred to in ASPR 15-101, by setting forth the appropriate Part in the contract, appending it to the contract, or incorporating it by reference in the contract; however:

- (i) any such contract may expressly make unallowable any item of cost which would otherwise be allowable under the Part of this Section which is made a part of the contract; and
- (ii) any contract subject to Part 3 or 4 (including those made subject thereto by Part 7) may expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this Section unless any such cost is expressly excluded under Part 3 or 4 (whichever is applicable).

## 15-102.2 Negotiation of Special Items.

(a) Precontract Costs. When special provisions for reimbursement of precontract costs are included in a contract in accordance with ASPR 15-204.3(j) and ASPR 15-502(a), they shall specify the period of time during which such costs must have been incurred as well as the type and amount of such costs.

(b) General Research Costs. In determining whether a special provision, providing for reimbursement of general research costs in accordance with ASPR 15-204.2(v)(2) and ASPR 15-502(m), will be included in the contract, the following factors shall be considered:

- (i) scope, nature, and quality of the contractor's independent general research program;
- (ii) capability of the contractor in the particular research field;
- (iii) benefits which may accrue to the Government;
- (iv) comparison of size and cost of contractor's previous years' independent research programs; and
- (v) proportion of Government business to contractor's total business.

Proposed paragraph 15-204.2(y) as recommended by Tax Subcommittee

(y) Taxes.

(1) Taxes are charges levied by Federal, State, ~~ex-legal~~ ☒ local, and foreign governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

Subpara (y) Taxes (cont'd)

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

~~Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.~~ [Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor.]

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government. [Any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties.]

21 June 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

1. This Memorandum, commenting upon proposed paragraph 15-204.2(y) concerning the reimbursement of taxes for certain cost contracts, is submitted in compliance with the assignment by your Committee of 5 June 1956.

2. This Memorandum represents the unanimous opinion of the Tax Subcommittee.

3. It is recommended that the first sentence of subparagraph (1) include a reference to taxes of foreign governments, inasmuch as Part 2 of Section XV is sometimes incorporated into contracts requiring performance in foreign areas. Such contracts sometimes do not have special tax clauses or have uncomprehensive ones. The first sentence of subparagraph (1) should read:

"Taxes are charges levied by Federal, State, local, and foreign governments."

4. The last two sentences of subparagraph (2) should be revised as follows:

"Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor."

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

This language will permit the reimbursement of costs of litigation and of interest and penalties in a number of situations where such costs are incurred for the benefit of the Government and without any fault of the contractor. As the paragraph now reads, there is serious doubt whether reimbursement would be allowed in a number of typical circumstances, including the following: (1) for interest and penalties incurred by a contractor for nonpayment of a tax where the Contracting Officer had not adopted a position, the nonpayment was reasonable, and the taxing authority made a typical belated assessment which included interest and penalties; (2) for costs incurred by a contractor in defending a suit for collection of tax brought by a taxing authority, in contrast with a suit for refund; (3) for costs incurred by a contractor in taking reasonable action pending receipt of instructions from the Contracting Officer. The suggested language will make the reimbursement of costs of litigation and of interest and penalties parallel, insofar as possible, to the treatment of these costs in the proposed tax clauses for fixed price contracts.

5. It is recommended that the following sentence be added to subparagraph (3):

"Any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

The purpose of this provision is self-evident. However, it is a refinement that may be deemed unnecessary for cost contracts.

6. For your convenience, there is attached hereto a copy of proposed paragraph 15-204.2(y) as the Tax Subcommittee recommends that it be amended.

*Mark H. Berens*

MARK H. BERENS  
1st Lt., JAGC  
Acting Chairman, Tax Subcommittee

Incl. - Draft of paragraph  
15-204.2(y)

21 June 1956

**MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE**

**Subj: Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n)  
(Overtime, Extra-Pay Shift and Multi-Shift Work) - Case 53-44**

1. Pursuant to Item 12 of ASPR Minutes of 8 May 1956, the subject material has been edited as set forth in TAB A.
2. In ASPR 12-102(b), the Edited Committee has deleted the word "generally", thus requiring prior authorization for premium work in all post-award instances, so that subparagraph (b) is now consistent with the concept adopted in ASPR 15-204.2(n).
3. Inasmuch as the draft submitted to the Editing Committee desired the word "firm" to be inserted "wherever language is intended to apply only to firm fixed-price contracts," the Editing Committee has appropriately added fixed-price incentive contracts in (b)(ii); but did not feel that it was the intent of the subject matter to include fixed-price contracts with escalation in (b)(ii), as well.

Lt. Col. Charles W. Wilkinson  
Army Member

John Green  
Chairman  
Navy Member

John W. Perry  
Air Force Member

Incl. TAB A



12-102 Overtime, Extra-Pay Shifts, and Multi-Shift Work. (a) Contracts shall be performed, so far as possible, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent possible, be limited to, and be the minimum required for, the accomplishment of the specific work. In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is a factor to be considered by the contracting officer along with other factors listed in ASPR 3-101. Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in pre-award negotiation or specific post-award instances, consideration shall be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) In the case of firm fixed-price contracts or fixed-price contracts with escalation, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts shall rest with the contractor except to the extent specifically provided for in the contract. In the case of:

(i) ~~cost reimbursement type contracts; and~~

(ii) ~~redeterminable fixed-price contracts and fixed-price incentive contracts, to the extent required by the contracting officer;~~

~~authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained if any premium direct labor costs are to~~

*be used in the contract, and to be reported as such by the contracting officer in redeterminable and incentive type fixed price contracts, however, an approval from the Government for the use of overtime, extra-pay shifts and multi-shifts must be obtained to sustain any premium labor costs to the contract.*

TAB-A

*approval should generally*  
be considered under the contract. Such ~~authorization~~ *approval* shall be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable and allocated on a pro rata basis to commercial as well as Government work. For further requirements, see ASPR 15-204.2(n). Nothing herein shall be construed to authorize the premium portion of overtime, extra-pay shift and multi-shift payments where the contractor is already obligated under the contract to meet the ~~desired~~ *required* delivery schedule without the right to additional compensation.

(c) In the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may generally rely upon the representation of the contractor that such authorization will not adversely affect the performance of other defense contracts. However, where two or more Departments have current contracts at a single facility so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department may adversely affect the performance of a contract or contracts of another Department, the Department desiring to give such authorization shall obtain the prior assent of the other Departments concerned. Such assent shall be given wherever possible. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

2 May 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Revision of ASPR 12-102 to Conform to Proposed ASPR 15-204.2(n)  
(Overtime, Extra-Pay Shift and Multi-Shift Work)  
Case 53-44

As requested at the April 6 meeting (see Item 1, Minutes, April 6 Mtg), the Staff has examined ASPR 12-102 to determine whether any revision thereof is necessary to conform to the proposed cost principle relating to the above subject.

It is concluded that a change should be made in ASPR 12-102(a) to indicate that in cost-reimbursement type contracts, prior approval is required for allowability of costs incurred in the payment of premium wages for direct labor, while such approval is not required in the case of similar payments for indirect labor.

It is proposed that ASPR 12-102(a) be revised to read substantially as set forth in Tab A (in which deletions are interlined and additions are enclosed within brackets).

It is also recommended that the following editorial changes be made in ASPR 12-202 at the same time:


a. Substitute the words "Department of Defense" for "each Department" in stating the policy.

b. Insert the word "-reimbursement" after "cost" wherever reference is made to "cost type contracts" or similar expressions.

c. Insert the word "firm" in front of the words "fixed-price contracts" wherever language is intended to apply only to firm fixed-price contracts.

d. Change initial capital letters of such words as "Contractor" and "Contracting Officers" to conform to current editing rules.

e. Include a cross-reference to ASPR 15-204.2(n).

  
W. K. Ghormley  
Brigadier General, USA  
Chairman, ASPR Committee

Attachment

COMPOSITE DRAFT OF ASPR 12-102  
SHOWING RECOMMENDED CHANGES

12-102 Overtime, Extra-Pay Shifts and Multi-Shift Work. It shall be the policy of each [the] Department [of Defense] that contracts will be performed, so far as practicable, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent practicable, be limited to and be the minimum required for, the accomplishment of the specific work.

(a) In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is to be considered a factor by the ~~Contracting Officer~~ [contracting officer] along with other factors listed in ASPR 3-101. Subsequent to the placing of a [firm] fixed-price contract, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts will generally rest with the ~~Contractor~~ [contractor]. On cost [-reimbursement] type contracts, and to the extent required by the ~~Contracting Officer~~ [contracting officer] on redeterminable fixed price contracts, however, the authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained to sustain the charge of any premium [direct] labor costs to the contract. Such authorizations shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. [The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. Further requirements for allowability of such costs are set forth in ASPR 15-204.2(n).] Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in

pre-award negotiation or specific post-award instances consideration should be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) Where two or more Departments have current contracts at a single facility, so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department will adversely affect the performance of a contract or contracts of another Department, the Department concerned will wherever practicable agree in advance as to the authorization of such work. Ordinarily, in the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may rely upon a representation of the ~~Contractor~~ [contractor] that such authorization will not adversely affect the performance of other defense contracts. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

(c) The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required. Nothing herein shall be construed to authorize payment for overtime, extra-pay shifts and multi-shifts where, under an existing contract, the ~~Contractor~~ [contractor] is already obligated without the right to additional compensation therefor to meet the desired delivery schedule, even though it is necessary for such a contractor to use overtime, extra-pay shifts or multi-shifts to meet such schedule.

MEMORANDUM TO CHAIRMAN, ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. The editing and reproduction of Part 2, Section XV, have been completed and a copy of the edited Part is attached hereto.

2. The edited part includes the Staff version of the previously reserved proposed ASPR 15-204.2(d), as revised at the ASPR Committee meeting of Tuesday, April 24, 1956, by the insertion of the words "under any such plan" in the last sentence of this paragraph after the word "allowable." It is understood that this paragraph is subject to the statement to be included in the notes and filing instructions in accordance with the action taken by the Material Secretaries on Action Paper No. 15 (Summary of Meeting No. 25 - Department of Defense Material Secretaries Council, 12 April 1956); and, also, that its inclusion in Part 2 is without prejudice to the respective Departmental positions with respect to the subject matter covered.

3. The following minor editing refinements have been made in the attached draft:

15-200 — Fifth line, the insertion of a comma after "subcontractors."

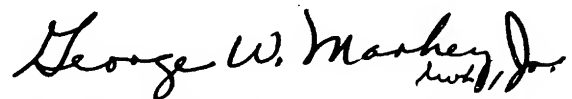
15-204.2(k) — First, second, and third lines of first sentence, commas replaced to clarify parenthetical aspect of the relative clause.

15-204.2(x) — First line, insertion of quotation marks around the term "special tooling" for purposes of consistent treatment based on action with respect to proposed ASPR 15-204.2(d) referred to above.

— Last complete line, comma deleted.

15-204.3(b) — Fourth line, the insertion of a comma in the parenthetical sentence after the word "programs."

15-204.3(k) — Third line, the word "or" corrected to "of."

  
GEORGE W. MARKEY, JR.  
Navy Member  
Chairman

Part 2 - Supply, Service, and Research and Development  
Contracts, with Commercial Organizations

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors, other than such contracts and subcontracts to which Parts 3, 4, or 7 apply.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations from the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations set forth in this Part 2 or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the

resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

#### 15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, provide uniformity of treatment for like cost elements, be applied consistently, and produce equitable results. A previously acceptable method shall be subject to reconsideration when:



- (i) any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or
- (ii) any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the inventories, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other relevant circumstances.

Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift work) units processed, and prime costs of units processed. Departmentalization or the establishment of cost centers may be necessary in order to allocate the indirect costs equitably. Factors to be considered in determining the necessity for departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include such items as costs of engineering supervision, engineering administration, and engineering supplies. Direct engineering activities from which indirect engineering costs may arise may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and

related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(u)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift work), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include the costs of sales promotion, advertising, distribution, and other related activities. Generally, such costs are not allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs) is a method which generally produces equitable results. Other methods acceptable where the circumstances are appropriate include allocation on the basis of:

- (i) processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct materials);
- (ii) factory input costs (processing costs plus direct material);
- (iii) cost of goods completed;
- (iv) cost of sales; and
- (v) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. The following advertising costs are allowable:

- (i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and

- (ii) help wanted advertising, as set forth in (s) below.

All other advertising costs are unallowable.

(b) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(c) Civil Defense Costs. Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional

exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. Costs of capital assets acquired for civil defense purposes shall be depreciated in accordance with (e) below. Except as specifically provided for in the contract, contributions to local civil defense funds, or to projects not on the contractor's premises, are unallowable.

(d) Compensation for Personal Services. Compensation is allowable. The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits, salaries, wages, royalties, license fees and bonuses. The total compensation of an individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered. Compensation to sole proprietors or partners, however, is allowable only to the extent specifically provided for in the contract. Any plan upon which deferred compensation benefits are based, other than pension plans (see (p) below), shall meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service. "Also, the amount allowable under any such plan for apportionment to contracts in any one year shall not exceed:

(i) the amount contributed under the plan for that year;  
or

(ii) 15% of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan;

whichever is the lower.

(e) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed:

- (i) upon the property cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954; or
- (ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income tax; and in either case
- (iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

- (i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (4) below); provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(4) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(f) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(g) Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable when it is the policy of the contractor to operate such services at a profit or at cost; provided, however, that such losses are allocated to all activities served. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(h) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition

to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (i)(3)(v), (p) and (w) below).

(i) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of providing a reserve for a self-insurance program are unallowable unless the program has been approved by the Military Department concerned; and
- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(j) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(k) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(e)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(2) Costs of maintenance and repair, which are delayed from a period prior to the contract for some reason such as abnormal operating conditions or lack of funds and are performed during the contract period, are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract are unallowable unless specifically provided for in the contract.

(l) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

(i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

(ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production;

are allowable.



(m) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work).

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of performance if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of:

(i) the cost to the transferor; or

(ii) the prices of other suppliers for the same or substantially similar items;

whichever is the lower, unless factors other than price warrant allowance on the basis of the cost to the transferor; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial

channels, a departure from this cost basis is permissible if the charge to the contract does not exceed:

(i) the transferor's sales price to its most favored customer for the same item in like quantity; or

(ii) the prices of other suppliers for the same or substantially similar items;

whichever is the lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer.

(n) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(o) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs, in connection with the filing of a patent application where title is conveyed to the Government, are allowable. (See also (u) and (v) below.)

(p) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by,

and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (p).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of:

- (i) contractors who are subject to Federal income tax; and
- (ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) the requirements of ASPR 15-201.2 shall be satisfied;
- (ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), shall not exceed —

- (A) the amount claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, the amount which could have been claimed and deducted for Federal income tax purposes in the current taxable period had such organizations been subject to the payment of income tax;
- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which —
- (A) are disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax-exempt organizations, could have been disallowed for tax purposes had such organizations been subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
- (A) when such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or in some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable —

(I) cannot be currently evaluated with reasonable accuracy; or

(II) have not been the subject of adjustment under (A) above;

pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for such subsequent termination credits or gains unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(q) Plant Protection Costs. Costs of items such as wages, uniforms and equipment of personnel engaged in plant protection; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(r) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(g)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

(i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;

- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organizations; and
- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(s) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(t) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(u) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. The contractor shall disclose to the Government the purposes and results of such independent general research.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (1) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract; provided the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line; and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204. 3(j)).

(v) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs incurred thereafter are unallowable.

(w) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement; (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

- (i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and
- (ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the employment of the terminated employees and equitably allocated to all work performed in the contractor's plant during that period. A reservation in the final release may be made



when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(x) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(y) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to
  - (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

(z) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(aa) Training Costs. Reserved.

(bb) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (m) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(cc) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(4) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(dd) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(f);

(ii) ASPR 15-204.3(j); and

(iii) ASPR 15-204.3(l).

15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(i).)

(c) Contributions and Donations. Contributions and donations are unallowable.

(d) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see ASPR 15-204.2(f), (h), and (z)).

(e) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(f) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(g) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(y) (but see ASPR 15-204.2(dd)(1)).

(h) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(i) Organization Costs. Expenditures, such as incorporation fees, attorneys' fees, accountants fees, brokers fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (g) above).

(j) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(k) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(e)(2) as to basis for depreciation).

(l) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(m) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) Advertising Costs, ASPR 15-204.2(a), last sentence;
- (ii) Depreciation, ASPR 15-204.2(e)(4), and (5), last sentence;
- (iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), first sentence;
- (iv) Recruiting Costs, ASPR 15-204.2(s), last sentence;
- (v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v), both provisos; and
- (vi) Taxes, ASPR 15-204.2(y)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;
- (ii) Compensation for Personal Services, ASPR 15-204.2(d) (5);
- (iii) Depreciation, ASPR 15-204.2(e)(5), first sentence;
- (iv) Food Service Costs and Credits, ASPR 15-204.2(g), last sentence;
- (v) Insurance and Indemnification, ASPR 15-204.2(i)(3)(iii) and (iv), and (4);
- (vi) Maintenance and Repair Costs, ASPR 15-204.2(k)(2);
- (vii) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(n), second sentence;

- (viii) Patent Costs, ASPR 15-204.2(o), second sentence;
- (ix) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), last sentence;
- (x) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(t)(3);
- (xi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v);
- (xii) Taxes, ASPR 15-204.2(y)(2); and
- (xiii) Travel Costs, ASPR 15-204.2(cc)(4).

OGC/GWM:lw  
April 9, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. Pursuant to the request of the ASPR Committee at the special meeting held on 6 April 1956, in connection with its consideration of the draft of Part 2, Section XV, dated 29 March 1956, the undersigned Special Editing Subcommittee has completed the editing of the material submitted. The attached TABS A, B, C, and D set forth composite drafts of this material as edited for retention in Part 2. The attached TAB H sets forth a proposed new Part 7 setting forth interim instructions for use in connection with facilities contracts and clauses in other type cost-reimbursement type contracts providing for the acquisition of industrial facilities.

2. In addition, this Subcommittee recommends that existing Parts 4, 5, and 6 be treated in the manner respectively set forth in the attached TABS E, F, and G, the proposed action in regard to these Parts to be effective simultaneously with the issuance of proposed Part 2. Similar action is recommended in TAB I with respect to existing Part 3.

CHARLES W. WILKINSON  
Lt. Colonel, SS JAG  
Army Member

GEORGE W. MARKEY, JR.  
Navy Member  
Chairman

WILLIAM M. MUNVES  
Air Force Member

*Revised report - Rec'd 4/12/56 -  
Page 1 revised - Tab I added.  
WGC*

OGC/GWM:lw  
April 9, 1956

T A B A

Proposed Revision of Title of ASPR Section XV, Part 2  
and ASPR 15-200 - Scope of Part

(For substitution on first page of draft of 29 March 1956)

Part 2-Supply, Service, and Research and Development  
Contracts, with Commercial Organizations  
~~Having Commercial-Type Accounting Systems~~

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors other than such contracts and subcontracts to which Parts 3, 4, or 7 apply. ]  
~~-having commercial-type accounting systems.- However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction.- It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.~~



TAB B

Proposed Revision of ASPR 15-204.2(f) - Depreciation  
(For substitution on page 7 of draft of 29 March 1956)

15-204.2(f) Depreciation.

\* \* \*

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof /is computed/:

(i) ~~is computed~~ upon the /property/ cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); and /or/

/ (ii) / in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income tax; and in either case /

~~(ii) / (iii) /~~ is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954 / ~~and~~

provided further that, in no event, shall the amount allowed for depreciation exceed the amount which would be authorized for tax purposes pursuant to the Internal Revenue Code of 1954.

Note: (1) The proviso contained in the last brackets is an edited version of a new substantive concept suggested by the Air Force and left as an issue at the special ASPR meeting of April 6, 1956. The Navy has opposed its inclusion. The Army has concurred with the Air Force.

(2) The two concluding sentences of the above subparagraph 2 should be added without change immediately following the proviso contained in the last brackets.

OGC/GWM:lwt  
April 9, 1956

T A B C

Proposed Revision of ASPR 15-204.2(j) - Insurance and Indemnification

(For substitution on page 9 of draft of 29 March 1956)

15-204.2(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes /securing the contractor against/ liabilities to third persons not compensated by insurance or otherwise.

OGC/GWM:lwt  
April 9, 1956

TAB D

Proposed Revision of ASPR 15-204.2(n) - Material Costs

(For substitution on pages 11 and 12 of draft of 29 March 1956)

15-204.2(n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work / (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work) / .

\* \* \*

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower /, unless factors other than price warrant allowance on the basis of the cost to the transferor /; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed ~~either~~ (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items /, whichever is the lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer / .

OGC/GWM:lwt  
April 9, 1956

T A B E

Proposed Revision of Existing ASPR Section XV. Part 4-  
Construction Contracts

Part 4 - Construction Contracts

\* \* \* \* \*

15-403   Examples of Items of Allowable Costs. . . .

(q) Pension ~~and retirement~~ plans in accordance with the ~~interpretation~~  
/principles and standards/ set forth in ~~paragraph 15-601-~~ ASPR 15-204.2(q)  
and group health, accident and life insurance plans (but see paragraph  
15-404(b), (d), and (m)).

OGC/GWM:ltw  
April 9, 1956

T A B F

Proposed Revision of Existing ASPR Section XV, Part 5 -  
Subjects Affecting Cost Which May Require Special Consideration

Part 5 - Subjects Affecting Cost Which May Require Special Consideration

15-500 Scope of Part. This ~~part~~/Part/enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in ~~Part 3,~~ Part 3, or Part 4 of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of ~~Part 2,~~ Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations.

OGC/GWM:lwt  
April 9, 1956

TAB G

Proposed Revision of Existing ASPR Section XV, Part 6 - Cost Interpretations

Part 6 - Cost Interpretations

Delete balance of this Part and substitute therefor the word "RESERVED".

Note: With respect to existing ASPR 15-601.2 the subject of pension plans is now covered in proposed ASPR 15-204.2(q) (pages 12 to 15 of draft of 29 March 1956).

In accordance with decision of the Procurement Secretaries, the subject of profit sharing is to be retained on the basis now appearing in existing ASPR 15-601.2(f). Presumably this subject will be covered under proposed ASPR 15-204.2(d) - Compensation for Personal Services which has been reserved in the draft of 29 March 1956.

With respect to existing ASPR 15-602 - Depreciation, this subject is now covered in proposed ASPR 15-204.2(f) in the draft of 29 March 1956. Existing ASPR 15-602 contains cross references only to existing ASPR 15-204(d), 15-205(b) and 15-205(o).

OGC/GWM:lwt  
April 9, 1956

TAB H

Proposed New ASPR Section XV, Part 7 - Facilities Contracts

Part 7 - Facilities Contracts

15-700 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for the acquisition of industrial facilities to which the Government takes title under the contract. This Part also applies to clauses in any other cost-reimbursement type contracts or cost-reimbursement type subcontracts thereunder, which clauses provide for the acquisition of industrial facilities to which the Government takes title.

15-701 Applicability. Pending publication of the principles and standards to be incorporated in this Part, Parts 2, 3, or 4 shall be used to the extent appropriate in accordance with Departmental procedures.

OGC/GWM:lwt  
April 9, 1956

TAB I

Proposed Revision of Existing ASPR Section XV,  
Part 3 - Research Contracts with Nonprofit Institutions

Part 3 - Research Contracts with Nonprofit Institutions

\* \* \* \* \*

15-304 Examples of Items of Allowable Costs. . . .

(g) Pension and ~~retirement~~ plans in accordance with the ~~interpretations~~  
/principles and standards/ set forth in ~~paragraph 15-601~~ /ASPR 15-204.2(q)/  
and group health, accident and life insurance plans (but see paragraph  
15-305(k)).



TABLE OF TITLES AND PARAGRAPH NUMBERS OF PRINCIPLES AND  
STANDARDS FOR SELECTED ITEMS OF COST (ASPR 15-204.2 and 15-204.3)

15-204.2 Costs Allowable in Whole or in Part.

- (a) Advertising Costs. /15-204.1/
- (b) Bidding Costs. /15-204.3/
- (c) Civil Defense Costs. /15-204.5/
- (d) Compensation for Personal Services. /15-204.6/
- (e) Contributions and Donations. /15-204.8/
- (f) Depreciation. /15-204.9/
- (g) Employee Morale, Health, and Welfare Costs and Credits.  
/15-204.10/
- (h) Food Service Costs and Credits. /15-204.4/
- (i) Fringe Benefits. /15-204.14/
- (j) Insurance and Indemnification. /15-204.15/
- (k) Labor Relations Costs. /15-204.17/
- (l) Maintenance and Repair Costs. /15-204.19/
- (m) Manufacturing and Production Engineering Costs. /15-204.20/
- (n) Material Costs. /15-204.21/
- (o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums.  
/15-204.24/
- (p) Patent Costs. /15-204.25/
- (q) Pension Plans. /15-204.26/
- (r) Plant Protection Costs. /15-204.27/

- (s) Professional Service Costs - Legal, Accounting, Engineering and Other. /15-204.29/
- (t) Recruiting Costs. /15-204.32/
- (u) Rental Costs (Including Sale and Leaseback of Facilities). /15-204.33/
- (v) Research and Development Costs. /15-204.34/
- (w) Royalties and Other Costs for Use of Patents. /15-204.35/
- (x) ~~Service and Installation Costs.~~ /15-204.36/ (deleted)
- (x) Severance Pay. /15-204.37/
- (y) Special Tooling Costs. /15-204.38/
- (z) Taxes. /15-204.39/
- (aa) Trade, Business, Technical, and Professional Activity Costs. /15-204.40/
- (bb) Training Costs. /15-204.41/
- (cc) Transportation Costs. /15-204.42/
- (dd) Travel Costs. /15-204.43/
- (ee) General. /15-204.23/

15-204.3 Unallowable Costs.

- (a) Bad Debts. /15-204.2/
- (b) Contingency Reserves. /15-204.7/
- (c) Entertainment Costs. /15-204.11/
- (d) Excess Facility Costs. /15-204.12/

April 2, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The joint report of the Editing Subcommittee and the Section XV Subcommittee, dated March 9, 1956, dealt with the three matters submitted by the Editing Subcommittee (report dated February 27, 1956), for resolution prior to completing the edited draft of Part 2, Section XV, and also submitted a proposed edited draft of the entire Part, prepared by the Editing Subcommittee. Except for the above three matters relating to Material and Supply Costs, Research and Development Costs, and Pension Plans, the Section XV Subcommittee had not participated in the edited draft. The ASPR Committee requested consideration of this edited draft (TAB B attached to the joint report of March 9, 1956), jointly, by the Editing and Section XV Subcommittees prior to further consideration by the ASPR Committee. Commencing March 16, 1956, the joint subcommittees met almost daily through March 28, 1956, preparing the attached draft of Part 2, Section XV, dated March 29, 1956.
2. The Section XV Subcommittee had fully recognized that its final draft as considered by the ASPR Committee (Minutes of November 22, 1955, Item 3) was in need of, and strongly recommended that it receive, substantial editing. After certain revisions by the ASPR Committee, that draft was submitted to the Editing Subcommittee for editing (Minutes of December 13, 1955, Item 4). In the course of consideration by the joint subcommittees of the draft of the Editing Subcommittee, it became apparent, with respect to various matters, that words originally included by the Section XV Subcommittee in its draft to express a particular principle or limitation or convey some other idea did not have the same meaning to accounting, procurement, and legal personnel. In other instances, it appeared that matters substantially agreed to in principle during the earlier deliberations of the Section XV Committee had either not been covered at all or were incompletely covered in the Section XV Subcommittee's draft.
3. In view of the above circumstances, when there was general agreement within the Section XV Subcommittee that a particular matter required discussion, the Chairman of the Editing Subcommittee, in presiding over the joint subcommittee sessions, permitted such discussion. In no case, was

such discussion permitted on the basis of a unilateral request by any member without concurrence of the Section XV Subcommittee. The Air Force and Army members of the Editing Subcommittee have questioned the authority of the joint subcommittees to undertake certain of these discussions and will file a separate report in regard thereto.

4. Except as indicated below and in the joint report of March 9, 1956, the attached draft of Part 2, Section XV, has the unanimous concurrence of all members of the Section XV Subcommittee from the standpoint of substance, and of the joint Editing and Section XV Subcommittees from the standpoint of editing. Owing to certain unavoidable circumstances, all members of the Section XV Subcommittee were unable to be present at the final joint session on March 28, 1956, and it has not been possible to clear the entire attached draft of Part 2 with each of them within the time required for submission to the ASPR Committee.

5. It is desired that the attention of the ASPR Committee be invited to the following specific matters. Unless otherwise indicated, reference to ASPR paragraphs and related page numbers are to such paragraphs and pages in the attached draft of Part 2, Section XV, dated March 29, 1956.

A. Joint Report of March 9, 1956.

I. Material and Supply Costs. In the first two quoted excerpts under 2.A., of the joint report of March 9, 1956, on page 1, change "transferor" to "transferee." The title of the paragraph in which this problem appears has been changed to Material Costs (see ASPR 15-204.2(n)(6), at bottom of page 11).

II. Research and Development Costs. Joint Recommendation I under paragraph 2.B. of the joint report of March 9, 1956 suggests that further study be given to use of the term "product line" (see ASPR 15-204.2(v)(3), on page 18).

III. Pension Plans. The issues within the Editing Committee with respect to this matter have been resolved, as discussed in paragraph 2.C. of the joint report of March 9, 1956. (See ASPR 15-204.2(q), pages 12-15 of attached draft which contains some additional minor editing refinements.)

Attention is also invited to the first paragraph on page 4 of the joint report of March 9, 1956 and the question is posed whether official acknowledgment should be made of the assistance furnished by the Internal Revenue Service.

B. Research and Development Costs - ASPR 15-204.2(v), page 18.

In the proposed ASPR 15-204.2(v), Research and Development Costs, the fourth and fifth sentences of subparagraph (2) (from "Generally, the contractor . . ." through the end of the subparagraph ) appear to set forth instructions to the contracting officer rather than cost principles. It is recommended that the fourth sentence be revised to read:

"The contractor shall disclose to the Government the purposes and results of any independent general research the costs of which are reimbursed in whole or in part by the Government."

Alternatively, it is suggested that the fourth sentence be deleted from Part 2 of Section XV and inserted elsewhere in ASPR as an instruction to the contracting officer. In any event, it is recommended that the fifth sentence, enumerating factors to be considered in providing for costs of independent general research, be deleted from Part 2 of Section XV and inserted elsewhere in ASPR, possibly either in Section III or in Part 1 of Section XV. See, also, C.V. below.

C. Certain Differences Between Draft for Editing and Attached Part 2.

I. Scope of Part (ASPR 15-200). The attached draft provides that the same treatment be given to clauses in supply or service contracts providing for the furnishing of industrial facilities and to facilities contracts, i.e., both are excluded from the coverage of Part 2. The draft for editing did not cover such facilities clauses. Filing instructions, however, should contain a notation that Part 2 may be used "to the extent appropriate" for these purposes pending publication of a separate Part covering facilities.

II. Base Period (ASPR 15-203.1(c)). The draft for editing (ASPR 15-203.5) did not contain the first sentence which has been proposed as a definition, or the third sentence.

III. Depreciation (ASPR 15-204.2(f)(2)). The draft for editing (ASPR 15-204.9(b)) includes the principles recognized under Section 167 of the Internal Revenue Code among any "generally accepted accounting principles" which may be used in the computation of depreciation. The attached draft requires the contractor to follow the same cost basis in regard to depreciation for contract costing as it followed for Federal income tax purposes.

IV. Rental Costs (Including Sale and Leaseback of Facilities). (ASPR 15-204.2(u)). Subparagraph (2) relating to charges in the nature of rent between organizations under common control was not included in the draft for editing although an analogous principle had

- (e) Fines and Penalties. /15-204.13/
- (f) Interest and Other Financial Costs. /15-204.16/
- (g) Losses on Other Contracts. /15-204.18/
- (h) Organization Costs. /15-204.22/
- (i) Precontract Costs. /15-204.28/
- (j) Profits and Losses on Disposition of Plant, Equipment, or  
Other Capital Assets. /15-204.30/
- (k) Reconversion Costs. /15-204.31/

been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

"and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

In regard to the costs of training "in" educational institutions, the proposed draft would make them unallowable "except to the extent specifically provided for in the contract in accordance with Departmental instructions." The words "in accordance with Departmental instructions" were included by the joint subcommittees in recognition of the fact that an area of increasing industry interest is involved and that it would be unwise not to develop a basis for consistent treatment. The added words appeared to afford the best means of achieving reasonable consistency within the limited time available for discussion of this item. The problem may well require additional study.

VII. General and Administrative Costs (ASPR 15-203.5, page 4). Under enumeration "(ii)" of factors to be considered in determining whether the method used for the allocation of general and administrative expenses provides for an equitable result, the proposed draft includes, "the results obtainable by using the input cost method" and also sets forth a definition of said method. This paragraph was otherwise subjected to substantial redrafting in view of the consensus of opinion within the Section XV Subcommittee that clarification was necessary.

VIII. Precontract Costs (ASPR 15-204.2(i), page 24). The parenthetical reference to ASPR 15-lxx was included by way of compromise of an issue within the Editing Subcommittee and, accordingly, this paragraph was not discussed in the sessions of the joint subcommittees. If Part 2 is approved with this reference included, the full reference to the appropriate paragraph in Part 1 should be inserted before Part 2 is released for printing.

D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) / ASPR 15-204.26d in the draft for editing/.

II. Overtime, Extra-Pay Shift, and Multi-Shift Premiums, (ASPR 15-204.2(o), page 12). Attention is invited to the recommendation with respect to this matter in paragraph 5.A. of the Editing Committee report of February 27, 1956. Discussions of the joint subcommittees emphasize that the term "authorization" and "prior approval" are not uniformly understood.

6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item



in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

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Chairman

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Lt. Colonel, SS JAG  
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APR 2 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Contract Cost Principles  
Separate Report of the Army and Air Force members,  
Editing Subcommittee

1. The Army and Air Force members of the Editing Subcommittee understood that the Editing Subcommittee's report of March 9, 1956 was returned to that Subcommittee solely to resolve, with the Section XV Subcommittee, any substantive differences between that report and the materials approved by the ASPR Committee in December 1955. On the contrary, a great part of the time of the two Subcommittees in the past two weeks has been devoted to consideration of entirely new substantive concepts put forth by various members of the Section XV Subcommittee. Since the Army and Air Force members of the Editing Subcommittee do not consider most of the changes made in the past two weeks necessary to conform the edited draft substantively to the draft approved by the ASPR Committee, and since they do not know which, if any, of the many new concepts have already been considered and rejected by the ASPR Committee or by the individual ASPR Committee members from the Departments in which the concepts originated, they are not able to recommend approval of the materials now being submitted to the ASPR Committee.

2. As examples, attention is directed to the paragraphs listed below.

a. 15-200 has been revised to exclude supply contracts with contractors not having commercial type accounting systems, and to exclude clauses in supply or service contracts providing for the acquisition of facilities.

b. 15-203 (c) has been revised by adding a first and third sentences. The first sentence defines "base period." The third sentence was added to preclude the idea that all indirect costs allocable to a contract which ran for several years had to be charged to one selected fiscal year.

c. 15-203.5 has been revised to include the "input cost method" as a yardstick for determining whether the contractor's method of distributing general and administrative costs is equitable and has deleted direct reference to inventory variations.

d. 15-204.2(f)(2) as approved by ASPR and as originally edited provided that depreciation should be "based upon original acquisition cost." As now changed the paragraph ignores acquisition cost and bases depreciation on whatever base is used for Federal income tax purposes. Read in conjunction with 15-204.3(j) this paragraph originally required that the contractor ignore, for Government contract cost purposes, both profits and losses on trade-ins. In addition, application of this paragraph (f)(2) as now revised to tax-exempt corporations which have commercial type accounting systems, will be difficult.

e. 15-204.2(f)(5) has been changed to prohibit use charges on assets acquired without cost to the contractor.

f. 15-204.2(n)(5) which did require that inventory discrepancies be included in arriving at "the cost of material" now requires that they be included in arriving at "the cost of performance."

g. 15-204.2(u)(2) is an entirely new paragraph limiting the rentals which may be charged between plants, divisions, or organizations under common control.

h. 15-204.1(3) has been changed to require disclosure to the Government of the purposes and results of related research and development for which the contractor is reimbursed in whole or in part by the Government.

i. 15-204.2(aa)(1) has been limited to the costs of the contractor's membership in organizations, as distinguished from the costs of membership of contractor employees.

j. 15-204.2(bb) has been changed to limit on-the-job training conducted by educational institutions to part-time training, and to require Departmental implementation before training in educational institutions can be provided for in a contract.

k. 15-204.3(d) has been changed to:

- (1) disallow costs of repairing idle and excess facilities;
- (2) limit the provision to contractor-owned facilities; and
- (3) clarify the assumed meaning of "standby purposes."

l. 15-204.3(j) has been changed by adding a cross reference which is in fact an exception.

3. If a generalization may be hazarded, the changes made in the past two weeks tend to negate the idea of looking to the "reasonableness" of costs incurred, and substituting therefor various rigid rules of allowability of costs. This trend in turn is attributable, at least in part, to the idea expressed by certain members of the Section XV Subcommittee that the doctrine of "reasonableness" expressed in 15-201.2 permits only questioning the reasonableness of the price paid as compared to what the contractor got but does not permit questioning the reasonableness of the contractor's incurring the cost in the first place. Possibly this limited interpretation of "reasonableness" is due to the school of thought which considers Part 2 of Section XV to be an audit manual.

4. The Army and Air Force members of the Editing Subcommittee recommend that the ASPR Committee review the materials now being submitted on the subject case as if they were an entirely new substantive submission from the subject Subcommittee, subject only to recognition that the submission has been edited.

Lt. Col. Charles W. Wilkinson  
Army Member  
Editing Subcommittee

John W. Perry  
Air Force Member  
Editing Subcommittee

February 27, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The Editing Committee has substantially completed its task with respect to the draft of Part 2, Section XV, submitted for editing in accordance with Item 4 of the Minutes of the ASPR Committee Meeting of 13 December 1955. In accordance with instructions of the Staff the edited Part is not submitted herewith; however, it can be submitted in final edited form immediately after resolution of the following three matters.

- A. Consideration by the ASPR Committee of certain new substantive matter introduced by the Editing Subcommittee in connection with Material and Supply Costs (proposed ASPR 15-204.2(n)(6)). This is discussed in paragraph 3. A. below.
- B. Consideration by the ASPR Committee, in connection with Research and Development Costs (proposed ASPR 15-204.2 (v)(3), of the need for clarification of the term "product line" and, also, of the possibility of an inequity in regard to the allocation of costs allowable under the subject subparagraph. This is discussed in paragraph 3. B. below.
- C. An issue within the Editing Subcommittee with respect to the costs of Pension Plans (proposed ASPR 15-204.2(q)). This is discussed in paragraph 3. C. below.

2. In addition to the foregoing there are certain other matters which the members of the Subcommittee wish to bring to the attention of the ASPR Committee. These matters are discussed in paragraphs 4 and 5 below. They do not necessarily require resolution by the ASPR Committee prior to reproducing the edited Part.

3. The matters requiring consideration by the ASPR Committee prior to reproducing the edited Part are discussed under A, B, and C of this paragraph. It should be noted that the numbering of the edited Part is entirely different from that in the draft for editing. For convenience of reference, the heading for each comment in this paragraph, as well as elsewhere in this report, sets forth the number of the applicable paragraph and subparagraph in the edited Part followed by brackets containing the corresponding number in the draft for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) / 15-204.21f/

The subject subparagraph as edited provides:

"(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, are allowable only to the extent of the cost to the transferor /, or the cost to the transferee, or the prices of other suppliers for the same or substantially similar items, whichever is lowest;/ provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed either (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items."

In editing this subparagraph, the Subcommittee has added the words in brackets at the end of the first sentence in the draft for editing, immediately following the word "transferor." The inclusion of these words presents an addition of substance which is for consideration by the ASPR Committee.

B. Research and Development Costs - ASPR 15-204.2(v)(3) / 15-204.34b(ii)/

The subject subparagraph as edited provides:

"(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see ASPR 15-204.2 (m)). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost type production contract if allocated to all production work of the contractor; provided the research is related to the contract product or product line. Such research costs are unallowable under cost type research and development contracts."

From the above, it will be noted that independent related research and development costs are allowable only if related to the contract product or "product line", but that such costs must be allocated "to all production work of the contractor." The Editing Committee is of the view that the term "product line" is susceptible of different interpretations and, in the interests of clarity, suggests that the ASPR Committee give consideration to the use of more meaningful terminology or to the development of a precise definition. Also, it appears that the requirement for allocating related research and development costs to "all production work of the contractor" may create an inequity. Under the circumstances, it may be desirable to consider whether the current requirement for allocation to "all production work of the contractor" should be revised to require allocation to all production work in connection with the "product line" as that term may subsequently be defined or otherwise clarified.

C. Pension Plans - ASPR 15-204.2(q) /ASPR 15-204.26/

The Chairman and the Army and Air Force members are not in agreement with respect to the subject paragraph as to the matters set forth below.

I. Substantive Change. The major difference of opinion arises over the question whether the edited version of proposed ASPR 15-204.2(q)(iii) acceptable to the Army and Air Force members varies substantively from the corresponding paragraph /15-204.26d/ of the draft for editing. The latter paragraph provides:

"d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting the current costs otherwise allocable or by obtaining realistic



recognition in the actuary's calculation of current costs so that the current costs do, in fact, reflect the discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and any necessary adjustment to pension plan cost incurred under the contract. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work."

There is set forth below, as proposed ASPR 15-204.2(q)(3)(iii), a consolidated edited version of the preceding paragraph. The Army and Air Force members are in agreement with all except the words in brackets which the Chairman considers necessary to avoid a substantive change in the draft for editing. If the Chairman's version is adopted, the underlined word "and" preceding the "or" in each of the first two sets of brackets should be deleted.

- "(iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

"(A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable or by obtaining realistic recognition in the actuary's calculation of current costs so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and /or/

"(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy,/ such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment."

II. Consistency with Interpretation in Part 6, Section XV.

A lesser difference also exists within the Editing Subcommittee with regard to proposed ASPR 15-204.2(q)(2). Here, the disagreement does not involve the question whether the edited version acceptable to the Army and Air Force members is substantively different from the corresponding subparagraph /15-204.26c/ in the draft for editing but the question whether it was intended that the latter draft should be significantly different from the interpretation set forth in Part 6, Section XV. The Chairman is of the view that an apparently unexplained significant difference does exist with respect to the coverage of pension plans for nonprofit and other tax exempt organizations.

Subparagraph 15-204.26c of the draft for editing provides:

"c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except

as otherwise determined unallowable under this paragraph. Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal income tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs."

It is the Chairman's understanding that no particular reason existed within the Section XV Subcommittee for significant departure from the current treatment of the pension plans of nonprofit or tax exempt organizations, set forth in part in ASPR 15-601.2(b), as follows:

"(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be accepted as charges to Government contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue-- when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs will be withdrawn accordingly."

Since Part 6, Section XV, received extended consideration by a Subcommittee addressing itself to that specific problem, the Chairman is of the view that significant departures therefrom should be avoided unless clearly intended and adequately justified.

There is set forth below, as proposed ASPR 15-204.2(q)(2) and (3)(i) and (ii), a consolidated edited version of the above subparagraph 15-204.26c, with the controversial portions favored by the Army and Air Force members underlined and those favored by the Chairman in brackets.

"(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans / shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service. /

"(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

"(i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;

"(ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory, / an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account / contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;"

February 27, 1956

Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service.

(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

- (i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;
- (ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory, / an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account/ contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;
- (iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

- (A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable or by obtaining realistic recognition in the actuary's calculation of current costs so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and /or/

February 27, 1956

(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy, / such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

NOTE — The above proposed ASPR 15-204.2(q) is a consolidated edited version of paragraph 15-204.26 of the draft for editing. The controversial material favored by the Army and Air Force members is underlined and that favored by the Chairman is in brackets.

The Chairman is of the view that the underlined third sentence of subparagraph (2) treats the problem of pension plans of non-profit and other tax exempt organizations in a manner which is too cryptic. If it is desired that the treatment of the problem be substantially parallel to that in existing ASPR 15-601.2(f), the Chairman recommends the deletion of the underlined sentence and substitution of the material in brackets which follows in both subparagraphs (2) and (3).

Attached as TAB A is a consolidated edited treatment of Pensions Plans -- ASPR 15-204.2(q) /15-204.26/ in which the controversial portions favored by the Army and Air Force members are underlined and those favored by the Chairman are in brackets.

4. The Chairman further invites the attention of the ASPR Committee to the following which is one of the matters referred to in paragraph 2 above as not necessarily requiring final action by the ASPR Committee prior to reproduction of the edited Part.

Pension Plans - ASPR 15-204.2(q)(3)(iii) (B) /15-204.26d/

- A. Implementation by "Side" Agreements. In connection with subject subparagraph (see TAB A attached), it is noted that the ASPR Committee recently considered the development of an agreement for Government-wide or DOD-wide use to provide for the recovery of reversionary credits of costs of pension plans (see ASPR Case 55-111, Item 11 of the Minutes of December 13, 1955). This case was withdrawn by the Army ASPR Committee Member on the basis of the prior consideration given to the general problem of reversionary credits by the ASPR Conference in Case 51-34 (see Item 8 of the Minutes of April 8, 1952). In that case, the ASPR Conference approved the report of the Contract Cost Subcommittee of 13 March 1952, which recommended as follows:

"The Committee feels that what is needed here is appropriate implementation by the military departments to their auditors and contract negotiators so that pension costs will be questioned and proper action taken thereon where appropriate. It does not believe that any action by the ASPR Conference beyond concurrence with this viewpoint is necessary or desirable at this time." (Emphasis added.)

It is understood that each of the Departments has been experimenting with the development of agreements to provide for the recovery of reversionary credits, of the same general type as referred to in Case 55-111, and that, in the interests of achieving uniformity, there has been informal coordination among representatives of the Departments. Paragraph 15-204.26d of the draft for editing (set forth in paragraph 3.C. above) refers to similar agreements as "side" agreements. Under the circumstances, the ASPR Committee may wish to consider whether further action on the matter of DOD-wide agreements providing for the recovery of reversionary credits is appropriate at the present time.

- B. Further Implementation. It is suggested that it may be desirable to consider whether further implementation of the subject subparagraph is appropriate. Attention is invited to ASPR Case 55-47 - Cost Reimbursement Type Contracts - Development of Standard Basic Forms for Release and Assignment of Credits, Refunds, and Rebates, for possible consideration in this regard.

5. The Editing Subcommittee invites the attention of the ASPR Committee to the following as one of the matters referred to in paragraph 2, which do not necessarily require final action by the ASPR Committee prior to reproduction of the edited Part.

Overtime, Extra-Pay Shift, and Multi-Shift Premiums- ASPR 15-204.2(o)  
/ 15-204.24/

The subject paragraph provides as follows:

"(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime,



February 27, 1956

PROPOSED ASPR 15-204.2

\* \* \*

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q). )

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans / shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the

TAB A

extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs."

It is considered that an appropriate subcommittee familiar with the policy set forth in ASPR 12-102 should be asked to reconsider that ASPR provision in the light of proposed ASPR 15-204.2(o). It is considered that particular attention should be addressed to the terms "authorization" and "prior approval", and to the matter of premium pay to indirect labor employees which is not now specifically treated in ASPR 12-102.

6. It is requested that the Editing Subcommittee be furnished instructions with respect to the matters set forth in paragraph 3 and that the ASPR Committee take such action as may be appropriate with respect to the matters set forth in paragraphs 4 and 5.

GEORGE W. MARKEY, JR.  
Navy Member  
Chairman

CHARLES W. WILKINSON  
Lt. Colonel, SS JAG  
Army Member

JOHN W. PERRY  
Air Force Member

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

November 1, 1955

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV

Your Subcommittee has reviewed the comments of the following with respect to subject: NSIA, MAPI, RETMA, NAM, AMA, C. of C., AIA, American Institute of Accountants, Council of Profit Sharing Industries, and Comptrollers Institute of America. These comments resulted in numerous revisions of our 3/23/55 draft.

At the outset, the subcommittee wishes to draw attention to certain major issues with industry which are historic and have not been resolved in this draft to the complete satisfaction of industry. While these issues have been taken up separately in this report, they are mentioned here because of their importance and long standing differences. They are (1) 15-203.3, Selling and Distribution Expenses, (2) 15-204.1, Advertising, (3) 15-204.11, Entertainment, (4) 15-204.16, Interest and (5) 15-204.18, Losses on Other Contracts.

Industry made the following general observations which the subcommittee believes worthy of mentioning. First, they object to the requirement, in many cases, that some costs to be allowable must be upon authorization by special contract provision or by written authorization of the contracting officer, rather than just the approval of the contracting officer.

Second, throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost-type contracts and it should not be made an audit manual for the various services.

The third observation is that detailed implementing instructions of the departments should be prepared prior to the publishing of this section.

The following paragraphs contain what the Subcommittee considered to be major unresolved issues with industry, certain differences which developed within the Subcommittee, and other comments on particular paragraphs of the draft.

15-200 Scope of Part.

INDUSTRY POSITION

A statement should be included to the effect that Section XV is not applicable to fixed price contracts, including those with price redetermination provisions.

#### SUBCOMMITTEE POSITION

The proposal is not acceptable since audit agencies have no alternative at present other than to use Section XV as a guide in auditing these contracts.

#### 15-201(b) Factors Affecting Allowability of Costs.

#### INDUSTRY POSITION

Costs should not be measured by the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs."

#### SUBCOMMITTEE POSITION

This new criterion is only one of the factors affecting allowability of costs. This does not take anything away from the contractor. If the reason for the deviation is justified, costs may still be allowed.

#### 15-203.2 Indirect Engineering Expenses.

#### AIR FORCE MINORITY POSITION

The Air Force Procurement member does not agree with the subcommittee's change of inserting the parenthetical phrase "(including independent research projects)" in paragraph 15-203.2.

The Subcommittee's purpose in inserting this phrase was to cover those few situations where contractors do not have a separate research department but perform their research in their engineering departments. To meet these situations, the subcommittee wanted a statement in Section XV to provide that where independent research is performed in an engineering department, allocation of indirect engineering expenses will be made to such research work.

The objection of the Air Force procurement member stems from the belief that such statement is unnecessary since the purpose of inserting the parenthetical statement is already accomplished by the present wording of recognizing independent research expenses in paragraph 15-204.34c:

"Independent research projects will absorb their appropriate share of indirect expenses of the department where research work is performed."

Furthermore, the insertion of the parenthetical statement makes paragraph 15-203.2 subject to misinterpretation since a literal reading of the paragraph with the insertion is likely to be to the effect that indirect engineering expenses of the engineering department should be allocated to research projects even though such work is performed in a research department independent and apart from the location of the engineering department. This, of course, was not what was intended. The Air Force procurement member, therefore, recommends the deletion of the parenthetical statement.

### 15-203.3 Selling and Distribution Expense.

#### INDUSTRY POSITION

Selling and distribution expenses are generally a cost which should be acceptable as allocable to Government contracts by associating such expenditures with an indirect benefit to Government work. It contends that the Government stands to benefit by being able to place orders for standard commercial products or specially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have capacities to produce efficiently and quickly the requirements of the Government that otherwise could not be possible without delays and expenditures. Industry would like the allowable costs more clearly defined. However, it is noted that the American Institute of Accountants says: "This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice."

#### SUBCOMMITTEE POSITION

Pure selling expense of the contractor as such is unallowable for the reason that it is not necessary and does not contribute anything to the performance of the contract. Generally, any type of marketing expense in the ordinary sense is not considered to be necessary in contract performance and is not required in doing business with the Government. However, the Subcommittee does feel that a reasonable demonstration that his technical, consulting and related beneficial services which are for purposes of application and adaptation of the contractors products may justify allocation of Government contracts. Any further liberalization would be unjustified.

### 15-203.4 General and Administrative Expenses.

#### INDUSTRY POSITION

It is not necessary to enumerate factors to be considered in determining whether a method of distributing general and administrative expenses will produce equitable results. The inclusion of such a listing will lead only to further confusion and may cause overemphasis on the use of the factors enumerated.

#### SUBCOMMITTEE POSITION

It is recognized that this paragraph involves a controversial matter and one which requires the consideration of many different points. However, it is felt that inclusion in this paragraph of several illustrative factors to be given consideration will not only insure that the listed factors are considered but will tend to indicate that there are many facets to the problem.

### 15-203.5 Base Period for Allocation of Indirect Expenses.

#### INDUSTRY POSITION

This paragraph is inconsistent with 15-203(b) and permits Government personnel to select the periods which must be used.

#### SUBCOMMITTEE POSITION

The Subcommittee fails to see any inconsistency between this paragraph and 15-203(b). One deals with the method of allocation and the other with the base period for allocation.

#### 15-204.1 Advertising.

#### INDUSTRY POSITION

The present limitations on advertising are too restrictive, and overlook the fact that any advertising is a normal cost of doing business from which the Government has derived benefit and as such should bear a portion of the expenses.

#### SUBCOMMITTEE POSITION

Advertising, generally, is not necessary in order for industry to conduct business with the Government. On the other hand, in the modified version, Government recognition has been accorded that portion of industry advertising which encourages dissemination of technical information within industry itself through certain media, the results of which benefit both industry and the Government, and the Government will share in its portion of same. One slight concession made by the Subcommittee is the deletion in the third line of paragraph a. (1) after the word "placed" of the phrase, "for the purpose of offering financial support to", and substituting the word "in". The change was made because of the difficulty of determining a contractor's intent and the words were not helpful in determining cost allowances. The Subcommittee set forth its views on this subject in greater detail in previous reports.

#### 15-204.6 Compensation for Personal Services.

The DOD position on profit sharing has not been determined by higher authority. Accordingly, the Subcommittee found it impracticable, because of cross references, to write this entire paragraph in final form until policy guidance is forthcoming.

#### 15-204.8 Contributions and Donations.

#### INDUSTRY POSITION

Industry has two objections to the proposed recognition of contributions and donations. First, industry objects to the exclusion of religious contributions and donations as a reimbursable cost. Next, industry feels that aside from the reasonableness of the amount of donations and the contractor's consistent practice of making such donations that the only additional limitation for the recognition of these donations is that the amount be deductible for federal income tax purposes. Accordingly, industry objects to the phrase "but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost."

#### SUBCOMMITTEE POSITION

(1) Religious donations should not be a reimbursable contract cost because (a) it cannot be said that religious donations are an ordinary and necessary business expense and (b) it is believed that the reimbursement to contractors of their religious donations from Public and Defense Funds would violate public policy.

(2) The deductibility of an item for federal income tax purposes should not be the only consideration for its recognition as a contract cost. For example, propriety and reasonableness are other standards. Hence, the phrase quoted above and objected to by industry is necessary in regarding the recognition of contributions and donations.

#### 15-204.9e Depreciation.

Protracted discussions in the Subcommittee failed to resolve the question of whether the term "emergency facility" or "emergency facilities" should be used in this paragraph.

#### MAJORITY POSITION

The issue arises because of the Army and Air Force policy of allowing contractors to select categories of facilities, for which separate findings are made on a determination, for true depreciation and those for normal depreciation.

#### NAVY MINORITY POSITION

Navy policy is that once a true depreciation determination is made, a contractor must elect to take true or normal depreciation for all the facilities covered by the determination. Hence, Navy insistence on the words "emergency facilities"

#### 15-204.11 Entertainment Expense.

#### INDUSTRY POSITION

Industry objects to the words "social activities" as it may create conflict with the provisions of 15-204.10 and 15-204.40. It further contends that unless there is an overriding public policy to the contrary, entertainment expenses reasonably allocable to Government contracts should be recognized, to the extent that it can be demonstrated that such expenses are ordinary and necessary to the business of a contractor.

#### SUBCOMMITTEE POSITION

There is no conflict with this paragraph and paragraphs 15-204.10 and 15-204.40. Furthermore, this type of expense is solely for the benefit of the contractor, serves no purpose to Government work and has been traditionally disallowed. The contractor may be placed in a favored class should he be allowed to recoup entertainment expense through Government contracts and is considered to be against public policy.

15-204.15(f) Insurance and Indemnification.

AIR FORCE MINORITY POSITION

The Air Force procurement member disagrees with the Subcommittee's wording of subparagraph (f) and believes that the following proposed wording would permit a more practicable application of accepting uninsured losses as a contract cost. The proposed change would remove uncertainty as to the Government commitments and liability in this area. It also makes the Government's commitment known at the time of contracting. Furthermore, it eliminates the Departmental approval of such cost (as the present language provides) and places it at the level of the procuring activity. It is proposed that (f) read:

"f. losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless authorized by special contract provision."

OSD MINORITY POSITION

It is recommended that the words, "unless approved by the Department concerned" be deleted in paragraph (f) since only one known Navy case was cited in substantiation of the phrase.

15-204.16 Interest and Other Financial Expenses.

INDUSTRY POSITION

Industry contends that interest should be allowable.

SUBCOMMITTEE POSITION

Interest has always been considered as unallowable because it represents a distribution of profits to persons who have advanced capital on a loan basis. The Subcommittee sees no reason why this position should be changed. More detailed reasons for disallowance are set forth in previous reports. In this connection, it should be noted that DOD Directive requires interest to be charged on advance payments.

15-204.18 Losses on Other Contracts.

INDUSTRY POSITION

Industry, in effect, requests that the portion of cost-participation contracts not reimbursed by the Government under that contract be allowed as a cost on other contracts.

SUBCOMMITTEE POSITION

This proposal is rejected since a contractor in accepting a cost-participating R&D contract expects that later production contracts will be obtained resulting in profit to compensate for earlier costs of participation.



15-204.19(b) Maintenance and Repairs.

INDUSTRY POSITION

Industry objects to the restriction of recognizing deferred maintenance expenses only by specific contract provision.

SUBCOMMITTEE POSITION

The requirement of a specific contract provision for recognition of this expense is necessary in order that the Government may exercise some control over the amount of deferred maintenance expense which may be charged against cost-type contracts. The contract provision requirement in no way lessens the recognition of this expense. Since such expenses could be substantial and the possibility of a dispute would always be present as to the amount which should be accepted as a contract cost, it seems best that this be covered by a contract provision.

15-204.21b. Materials and Supplies (Cash Discounts)

INDUSTRY POSITION

Industry questions the requirement of the Government that cash discount be taken as a credit against the cost of materials, their theory being that cash discount is actually financial income comparable to interest as a financial expense, and since interest is not considered an allowable cost, cash discount credits should be omitted from consideration.

SUBCOMMITTEE POSITION

The subject of cash discount credit is in an area completely separate from that of financial expense or financial income. Classifying cash discount as financial income is fallacious since realized income cannot arise through the operation of buying. Net prices are substantially on a cash basis and therefore represent the most effective costs. It is the net price which a seller expects to receive, and a buyer expects to pay. The cost of materials therefore is represented by the total outlay of cash or its equivalent for the purchase of the materials; if the cash paid out includes a reduction for allowances or credits taken by the contractor, the net amount paid represents the true cost of the material.

AIR FORCE MINORITY POSITION

The Air Force Procurement member believes the third sentence of this subparagraph is subject to misinterpretation since it gives the impression that a contractor has the election to credit discounts, rebates, etc. to material costs or to indirect costs. The Air Force Procurement member would clarify the 3rd sentence by adding the following: "which ever method has been consistently followed by the contractor." These added words are considered necessary since it is believed that the requirement for a consistent application of these credits is not necessarily found by reading the questioned sentence in light of the Basic Principles and Standards (15-201).

15-204.21e. Materials and Supplies (Write-down of Inventory Values).

INDUSTRY POSITION

Write-down of inventory value should be allowed as a contract cost.

SUBCOMMITTEE POSITION

Although this item is not a major objection by industry, the Subcommittee's position is that there is little, if any, merit to industry's contention in cost-type contracts. Write-down of material costs would, of necessity, have to apply to material costs unrelated to a Government cost-type contract and, therefore, should be absorbed by the business to which the (write-down of value) applies.

15-204.24 Overtime, Extra Pay Shift and Multi-Shift Premiums.

INDUSTRY POSITION

Industry wants restriction lifted with respect to cost of overtime and shift premium on indirect labor. The suggested change in the draft may remove some of the objection. As to such cost on direct labor industry wants no restriction except as provided by contract terms in accordance with the contractor's practices and procedures, this being a standard operating procedure for most companies and such provision is often made for such procedures in union contracts. This argument does not in any way appear to bind the Government.

SUBCOMMITTEE POSITION

For the contractor to be required to identify separately shift premium and overtime on his books is a sound practice and one which requires but little or no overhead cost to segregate. This has been traditional with the Government to restrict and control overtime and extra pay shift cost. Not to do so would invite the contractor to work normal hours on commercial work and run up large amounts of extra pay and overtime cost. Extra pay cost and overtime premium on indirect labor is allowable on a pro rata basis to commercial and Government provided it is otherwise reasonable.

15-204.25 Patent Expenses.

INDUSTRY POSITION NO. 1

Costs of filing patent applications by a contractor should be allowed even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention.

SUBCOMMITTEE POSITION NO. 1

This comment was rejected on the basis that the contractor gets title to the patents and the primary benefits therefrom. This would amount to a windfall to the contractor if the Government paid.

## INDUSTRY POSITION NO. 2

Add to allowable costs "the defense of patent infringement litigation".

## SUBCOMMITTEE POSITION NO. 2

Under the Act of June 25, 1910, as amended, (28 USC 1498), only the Government can be sued for patent infringement on contractor's production for the Government. If a contractor is sued for patent infringement, it must be for its own commercial production. Therefore, there can be no costs to industry for defense of patent infringement litigation, except such as are passed on to industry by the Government through the Patent Indemnity clause. To allow such costs would conflict with the purpose of the Patent Indemnity Clause.

### 15-204.29c. Legal Fees.

## INDUSTRY POSITION

The cost of successful anti-trust suits brought by the Government and the cost of successful prosecution of claims against the Government should be allowable on the premise that these are ordinary, necessary and proper expenses of doing business and therefore should be considered allowable.

## SUBCOMMITTEE POSITION

Costs incurred in these connections, whether the results of the actions are successful or not, are unallowable. Reimbursement of litigation costs where the Government is a party to the suit is obviously untenable. The Government can not financially support the party with which it is engaged in legal dispute.

### 15-204.30 Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets.

## INDUSTRY POSITION

Such profits and losses should be allowable to the extent that they represent adjustments to depreciation on assets acquired for Government business.

## SUBCOMMITTEE POSITION

The subcommittee agrees with this contention but feels that it would be impractical, if not impossible, to distinguish between that portion of a profit or loss which represents an adjustment of depreciation and that which was caused by fluctuations in the general price level.

### 15-204.31 Reconversion Expenses.

## INDUSTRY POSITION

Industry comments ran the complete gamut from general agreement with the item as drafted to an extreme statement by Auto Manufacturers Association that "we can see no reason for disallowing any conversion expenses".

#### SUBCOMMITTEE POSITION

It is apparent that industry should seek a birth-to-burial treatment of reconversion expenses; however, the comments furnished no valid reasons for changing the principle. Specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the Government's and contractors' interests. All items not specifically provided for in the initial contract or by modification are not allowable.

#### 15-204.33 Rentals of Plant and Equipment.

#### INDUSTRY POSITION

The restriction on amounts of allowable rent for facilities covered by sale and lease-back agreements is not equitable. As long as the rents are reasonable in the light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement the Government's interests are adequately protected. In addition, the Government would be penalizing companies who have sale and lease-back agreements as contrasted with companies holding conventional leases.

#### SUBCOMMITTEE POSITION

Sale and lease-back agreements are primarily entered into to provide additional working capital, without borrowing funds, or issuing additional capital stock. Another reason could be to obtain tax benefits. To accept the risk, financing and profit factors included in the rental of sale and lease-back facilities would be contrary to our position regarding interest as a nonallowable cost. Furthermore, the accelerated amortization usually included in the rental may represent an unreasonable contract cost.

#### 15-204.34b(1) Research and Development (General Research)

The subcommittee concurs with the violent objection of industry to placing a ceiling of 25% on general research costs. The draft takes a new approach of allowing "the allocable portion of 75% of the allowable costs of a contractor's independent general research". Under this arbitrary formula, there is no penalty for being predominantly a defense contractor but some restriction is placed on such a contractor from going whole hog on general research by forcing him to place some of his own funds into such projects. Some Subcommittee members are not adamant in the position on the percentage figure and are willing that the figure be as high as 90%. Other Subcommittee members feel that 75% is a reasonable figure but should be followed by the parenthetical insertion "(or such other percentage as may be agreed upon and set forth in the contract Schedule)" since flexibility is desirable in this area.

#### 15-204.35 Royalty Payments.

#### INDUSTRY POSITION

Industry takes objection to the limitation on the allowability of royalties where royalties paid or payable for the right to use patents necessary

for the proper performance of a contract and where the Government does not already have a royalty-free license to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Contracting Officer. Industry contends that it should be permitted to manufacture products under license agreements which they would otherwise have to purchase and that payment for same should not be subject to such limitations.

#### SUBCOMMITTEE POSITION

In the Subcommittee's opinion, the payment of royalties to contractors under the circumstances described should be circumscribed by contract provisions or effected under the Contracting Officer's cognizance. Because fees for use of patents, where the Government does not have a royalty-free license to use same, may often be predicated on the highest rates the market will bear, and since payment limitations are difficult to establish where effective competition does not exist, the Government has established procedures leading to the reduction of royalties where royalty payments in connection with contract performance are deemed excessive. The inclusion of the limitations in the revision permits review of the circumstances surrounding the incurrence of royalty payment costs and assures control by the Contracting Officer. In addition to the cost feature, review by the Government can be effected to assure that the Government does not already have a royalty-free license to use the patent concerned. In summary, Contracting Officers can determine if the royalty costs are bona fide and reasonable.

#### 15-204.36 Service and Installation Expenses.

##### BACKGROUND

The 3/23/55 draft contained a provision (now deleted) concerning correcting product defects and replacing defective parts.

##### ASPR POSITION

ASPR 7-203.5 - Inspection of Supplies and Correction of Defects - provides that the Government will pay these costs unless caused by high officials of the contractor.

##### SUBCOMMITTEE POSITION

When such costs are incurred due to failure to comply with contract terms or specifications, or from causes considered to be beyond the area or reasonableness, such costs including any applicable overhead should be unallowable. The Subcommittee will present an actual case in substantiation of its recommendation that the ASPR Committee give serious consideration to amending ASPR 7-203.5 along the above lines.

#### 15-204.37 Severance Pay.

##### INDUSTRY POSITION

The portion of the revised provision relating to contract costing of mass or

abnormal severance pay is impractical and would be difficult and cumbersome to apply, and the cost of severance pay, generally, should be handled on a basis conforming with accepted accounting principles and practices and the established policy of a contractor, rather than policy which constitutes an implicit agreement on the contractor's part. Industry also feel that perhaps allowability should be provided for on either an actual or an accrual basis.

#### SUBCOMMITTEE POSITION

The treatment as proposed for mass severance pay is the most practical and realistic approach to a problem which concerns an unpredictable contingency. It is felt that a contingency reserve for mass severance pay is too conjectural to be considered a cost. The Government should not obligate itself for more than its pro rata share of severance wage payments actually made, in accordance with a policy reflecting implicit agreement by a contractor, on the basis of its ratio of participation in the contractor's total business during the period of employment of the individual involved.

#### 15-204.39a(3) Taxes

##### INDUSTRY POSITION

This clause should be eliminated as in many cases the cost of securing the exemption exceeds the amount to be saved.

##### AIR FORCE MINORITY POSITION

The Air Force members believe there is merit in industry's comment and propose the clause be revised to read as follows:

"Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government."

#### 15-204.39b. Taxes.

##### INDUSTRY POSITION

Industry generally contends that this paragraph should be revised to allow cost of taxes, interest, penalties and expenses of contractor's acts in resisting assessments or attempting to secure refunds, without the imposition of the restrictions presently included in this paragraph as in certain situations contractors cannot possibly or reasonably comply with these requirements.

##### SUBCOMMITTEE POSITION

The restrictions imposed by this paragraph are reasonable in that they merely require the contractor to obtain and follow instructions from the contracting officer in cases where there is a doubt as to the legality or correctness of a tax assessment.

15-204.40 Trade, Business and Professional Activities (Exhibitions).

INDUSTRY POSITION

The expenses of holding exhibitions is a required cost of doing business, as normal and essential as expenses incident to meetings and conferences, and as such should be allowable. Further, the revision is unduly restrictive in that it relates only to expenses incurred at meetings and conferences when the primary purpose of the incurrence is the dissemination of technical information or information aimed at the stimulation of production, and does not include expenses of exhibitions incurred for dissemination of information to the trade, the public, prospective employees, etc., about the particular business.

SUBCOMMITTEE POSITION

This matter is quite similar to the problem of allowability of advertising. Doing business with the Government does not presume that dissemination of information about the business to the trade or public through exhibitions is necessary. The Government is agreeable, however, to accepting its pro rata share of expenses incurred for the dissemination of technical information or information aimed at stimulation of production through meetings or conferences. The exhibitions referred to by industry are those held for purposes other than these; therefore, the costs thereof are considered unallowable.

GENERAL COMMENTS

1. Some existing subcommittee members do not necessarily concur with every view expressed by their predecessors but concurred in the Report to expedite consideration.
2. The need for editing is recognized.
3. GAO concurrence has not been obtained.
4. Prior to publication, Part 1 must also be revised (the Subcommittee has made considerable progress on revised Part 1) and certain cross-referencing accomplished on existing Parts 3 and 4.

SECTION XV SUBCOMMITTEE

MEMBERS:

H. H. Gallup (Chairman)  
Maj. J. O. Hunnicutt  
Mr. E. M. Wiseman  
Mr. James Ruttenberg  
Mr. A. C. Sawallisch  
Mr. P. M. Southwell  
Mr. George Rudigier

27 April 1955

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Depreciation Cost Interpretation for  
Inclusion in Part 6, Section XV, ASPR

1. Reference is made to the memorandum for the Chairman, ASPR Committee, dated 24 March 1955, subject as above, in which the Editing Committee presented an edited proposed ASPR 15-602. This was discussed at the ASPR Committee meeting on 5 April 1955, and returned to the Editing Committee for further revision, as indicated in the minutes of that meeting.

2. The Editing Committee has reviewed proposed ASPR 15-602 in the light of the mentioned minutes, and recommends only that ASPR 15-602.1 be revised to read as follows:

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b), and 15-205(o), with regard to contracts executed on or after the date of its issuance. It shall also apply to existing contracts in those cases where such interpretation was (i) specially provided for in the contract or in the record of contract negotiations, or (ii) in the absence of specific agreement, where the parties have reserved final resolution of the question of cost allowance in regard to depreciation pending the issuance of an interpretation by the Departments with respect to the applicability of Section 167 of the Internal Revenue Code of 1954.

3. The Editing Committee has considered other suggestions contained in the minutes, but does not feel that the proposed ASPR 15-602 should be further revised to quote or paraphrase the statute, or to make reference to "assets" involved.



MEMO FOR: ASPR COMMITTEE  
SUBJECT: Case 53-44...

27 Apr 55

4. The Navy Member presented to the Editing Committee, for consideration, a memorandum to him, (Tab 1), recommending further change to ASPR 15-602.2, as set forth in Inclosure 1 to mentioned memorandum from the Editing Committee, dated 24 March 1955. The Editing Committee feels that this proposal should be considered by the ASPR Committee, and, therefore has taken no affirmative action on the recommendation.

1 Incl  
(Tab 1)

MAURICE LEVIN  
Lt. Colonel, JAGC  
Army Member  
Chairman

GEORGE W. MARKEY, JR.  
Navy Member

WILLIAM MUNVES  
Air Force Member

1  
MLB/RKM:dmc

6 April 1955

MEMORANDUM FOR MR. GEORGE W. MARKEY, JR.

Subj: Case 53-44 - Depreciation Cost Interpretation for Inclusion in  
Part 6, Section XV, ASPR

1. In accordance with our conversation today and as requested by you, I would offer the following suggestion for inclusion in the Editing Subcommittee's draft regarding subject case to be added to your last sentence in paragraph 15-602.2:

"Allowances for "true depreciation" as that term is defined in DOD Instruction 4105.34, 1 July 1954, shall be in accordance with said Instruction."

Change period to comma and follow with:

and applied on a straight line method, for both the emergency and the post emergency periods, as those periods are defined in the Instruction.

2. In other words, it is felt that since "true depreciation" in most cases allows some accelerated depreciation, it is not felt that the contractor should have a further acceleration factor because of the application of the new allowable "tax methods" of depreciation. As stated to you in today's conversation this device has already been attempted unsuccessfully by one contractor who has been given a determination of true depreciation by the Navy Emergency Facilities Depreciation Board.

Very respectfully,

R. K. MAAS  
LCDR., SC, USN  
Member, Navy Emergency  
Facilities Depreciation  
Board

Copy to:  
Mr. G. C. Bannerman

*Incl 1*

24 March 1955

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Depreciation Cost Interpretation for Inclusion  
in Part 6, Section XV, ASPR

1. Reference is made to paragraph 4 of the minutes of the ASPR Committee meeting of 15 March 1955.

2. In the light of the discussion at that meeting, the Editing Subcommittee has prepared the attached draft of ASPR 15-602 (Incl 1) (i) to make clear that the issuance of this regulation effective from the date of publication was not intended to alter in any way any like interpretations that have been followed in the past with respect to contracts; (ii) to include reference to "true depreciation"; and (iii) to delete the quotation of the text of Section 167 of the Internal Revenue Code of 1954.

3. With reference to proposed ASPR 15-602.1 your Subcommittee considered the desirability of clarifying the effect of this interpretation on past or current contracts by an appropriate note accompanying the issuance of this regulation or through language to be included in 15-602.1. The latter was considered the more practicable method. Such notice, if inserted in a note, might readily be overlooked.

4. Your Subcommittee has considered the desirability of including the text of Section 167 of the Internal Revenue Code of 1954. It is felt that the inclusion of the text alone would be incomplete unless there were also included the regulations issued by the Internal Revenue Service. It was not felt by your Subcommittee that there was any need for encumbering the ASPR with such matter. Those charged with the responsibility of evaluating depreciation must necessarily acquaint themselves with all necessary material on the subject and consult with appropriate personnel.

5. All of the undersigned concur.

1 Incl  
Draft of ASPR 15-602

MAURICE LEVIN  
Lt. Colonel, JAGC  
Army Member - Chairman

GEORGE W. MARKEY, Jr.  
Navy Member

WILLIAM MUNVES  
Air Force Member

15-602 - Depreciation.

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASFR 15-204(d), 15-205(b), and 15-205(o), and is effective from the date of its issuance; provided that, where this cost interpretation has been and is being followed, the statement herein of an effective date is not intended to affect such interpretation.

15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation" as that term is defined in DOD Instruction 4105.34, 1 July 1954, shall be in accordance with said Instruction.

15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records.

Incl 1

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply and Logistics

11 March 1955

*earl  
53-44*

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Depreciation-Cost Interpretation for Inclusion in Part 6,  
Section XV, ASPR.

1. In accordance with instructions contained in item 1 of the minutes of the ASPR Committee meeting of 3/1/55 this Subcommittee met on 3/10/55 for the purpose of developing a cost interpretation to provide guidance with respect to depreciation pursuant to Section 167(b), as limited by Section 167(c) of the Internal Revenue Code of 1954.

2. Attached hereto is a proposed cost interpretation unanimously recommended by the Subcommittee for inclusion in Part 6, Section XV of the ASPR.

3. In the development of this proposal it was the opinion of the Subcommittee that the full text of Section 167 of the Internal Revenue Code of 1954 should be included for two reasons, (i) to avoid problems which might arise from paraphrasing or excerpting the provisions thereof, and (ii) to assure that the information contained therein was readily accessible to all procurement and audit personnel throughout the Department of Defense.

Lt. Col. J. E. Ellis  
Maj. S. L. Baird  
Maj. J. O. Hunnicutt, Jr.  
R. M. Kee  
A. C. Sawallisch  
J. T. Regardie  
P. J. Wedel  
J. F. Lenahan

Attachment

## 15-602 Depreciation

15-602.1 Applicability and Effective Date. This cost interpretation pertains to paragraphs 15-204(d), 15-205(b), and 15-205(c) and is effective from the date of its issuance.

15-602.2 Allowances for Depreciation. Allowances for depreciation as provided in Section 167 of the Internal Revenue Code of 1954 (quoted below), subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes.

### "Section 167. Depreciation.

(a) General Rule.-- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

- (1) of property used in the trade or business, or
- (2) of property held for the production of income.

(b) Use of Certain Methods and Rates.--For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

- (1) the straight line method,
- (2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),
- (3) the sum of the years-digits method, and
- (4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection(a).

(c) Limitations on Use of Certain Methods and Rates.-- Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more--

- (1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

- (2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

(d) Agreement as to Useful Life on which Depreciation Rate is Based.-- Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by registered mail is served by the party to the agreement initiating such change.

(e) Change in Method.-- In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) to the method described in subsection (b) (1).

(f) Basis for Depreciation.-- The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 (Adjusted Basis for Determining Gain or Loss) for the purpose of determining the gain on the sale or other disposition of such property.

(g) Life Tenants and Beneficiaries of Trusts and Estates.-- In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(h) Depreciation of Improvements in the Case of Mines, Etc.--

For additional rule applicable to depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber, see section 611 (Allowance of Deduction for Depletion).

15-602.3 Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records.

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

Supply and Logistics

15 December 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 Revision of Section XV Cost Principles.

1. In accordance with item 5 of the minutes of the ASPR Committee meetings of 11/30/54, 12/2/54 and 12/6/54, together with verbal instructions and guidance provided at these meetings, this Subcommittee met on 12/11/54 and 12/14/54 for the purpose of reconsidering and revising certain paragraphs of the 15 November 1954 draft as follows:

15-204.6 (c) Delete subparagraph as written and substitute the following therefor: "The cost of options to purchase stock of the contractor corporation granted to employees as part of their compensation may be allocated to Government contracts within the following limitations:

(i) The cost of stock options to the grantor corporation is the excess, if any, of the fair market value of the stock over the option price on the date the option is granted to a specific individual and shall not exceed 15% of the fair market value on such date.

(ii) Costs to be recognized will be only those resulting when options are exercised by the employee.

(iii) For allowance purposes, the cost of options exercised will be amortized equally over a period of not less than 5 years from the date option was exercised.

(iv) The cost will be allocated to all work of the contractor, including Government contracts."

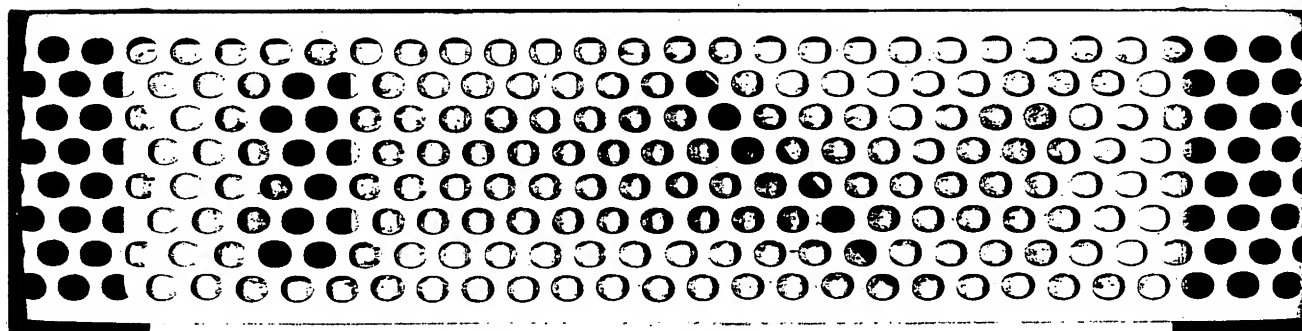
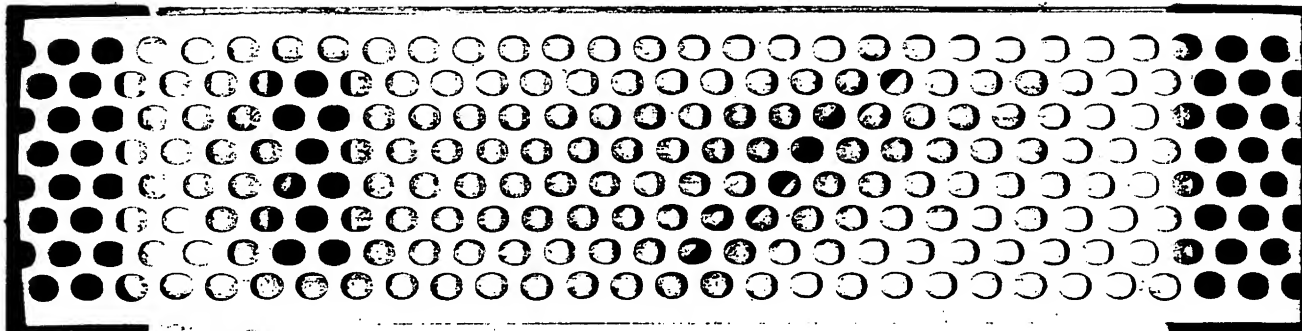
15-204.6 (d) 2. Delete second sentence; statement to be made the subject of new subparagraph 15-204.6 (g) below.

15-204.6 (e) 1. At end of sentence add cross-reference, "and g below".

15-204.6 (e) 2. In first sentence after words "under subparagraph d", add cross-reference "and g below".

15-204.6 (f) In second sentence after words "under paragraph d above", add cross-reference "and g below".





(d) If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are equitable. Where materials in stock at the commencement date of the contract are subject to Government material controls and have a provable replacement cost significantly higher than book cost, the contractor and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

(e) Reasonable charges arising from differences between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

(f) Ordinarily, sales or transfers of materials and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissible provided that the price charged to the contract does not exceed the lower of (i) the transferors sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other supplies for the same or substantially similar items."

Lt. Col. J. M. Railing  
Lt. Col. J. B. Ellis  
P. M. Southwell  
J. T. Regardie  
A. C. Sawallisch  
R. M. Kee  
J. F. Lonahan  
H. H. Gallup

15 November 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. Attached for consideration of the members is a copy of the latest draft of Part 2, Section XV, which has been revised in the light of the comments received from the various activities in the Military Departments and the policy guidance established by your Committee on 26 October 1954.

2. For the purposes of the record, the history of this project is set forth below:

DATE in 1954	STATUS
9 February	Project assigned to Subcommittee.
8 March	McNeil-Webster Agreement on cost principles.
22 June	Draft submitted to Military Departments for comment by 1 August.
24 August	Subcommittee commenced to consider comments.
26 October	Policy guidance on two issues given by ASPR.

The Subcommittee has been devoting two full days a week to this effort since 27 April 1954, except for a vacation recess of one month.

3. The Subcommittee wishes to point out that the attached effort represents a new approach to cost principles and numerous ideas were discussed at length prior to Subcommittee agreement on the manner in which the various principles should be stated.

4. With respect to the future activities of this Subcommittee, further guidance is requested from the ASPR Committee. Considerable work has been accomplished on revising Part 1 of Section XV, but the effort has not been completed since the Subcommittee does not know what parts are to be included in the new Section XV. It should be pointed out that there are several statements in the attachment which provide that the cost is not allowable unless specifically provided for in the contract. While some effort has been expended in preparing guidelines as to when these costs may be allowable and provided for in the contract, it is the consensus that additional work should not be done on these guidelines until Part 2 is accepted.

H. H. Callup



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS

PP

8 March 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

FROM: Director of Procurement & Production Policies

SUBJECT: Agreement Reached by Panel of Department of Defense and Service Representatives in Mr. McNeil's Office, 1600 - 1700, 1 March 1954

1. The memorandum submitted by Mr. Webster was accepted in principle. These principles are as follows:

a. There will be included in the revision of Section XV, relating to cost-type contracts, a definite statement that the instructions covering "cost principles" for use in connection with cost-type contracts are not applicable to fixed-price type contracts.

b. In connection with fixed-price contracting, including redeterminable prices or incentive prices, the analysis and interpretation of costs shall avoid the use of such terms as "allowable" and "unallowable".

c. Any instructions to negotiators as to how to deal with cost data or as to the considerations to be examined in connection with negotiating fixed prices should not be in a publication which is available to contractors.

d. There should be furnished to industry guidance as to reporting of costs.

2. In addition, the following principle was agreed to:

a. Under fixed-price contracts, auditors perform a service function, which is primarily to explain the nature and content of the various elements of cost submitted by the contractor.

3. It was agreed to proceed as follows:

a. The ASPR sub-committee will expedite revision of Section XV for submission to the ASPR Committee. The revision will pertain solely to cost-type contracts and will substantially expand the cost interpretations.

b. The Office of the Assistant Secretary of Defense (Comptroller) will prepare a document relating to the reporting and analysis of costs on fixed-price type contracts. Decision as to whether this document will be incorporated in an Audit Manual or in ASPR as a new Section or a sub-division of Section XV will be postponed until the various projects mentioned above are completed.

c. The cost principles in draft documents heretofore prepared by Mr. Bordner and by the ASPR sub-committee will be reviewed in the above drafting.

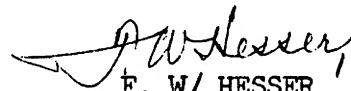
d. This work to be undertaken concurrently with a sufficient interchange of ideas to incorporate all basic principles.

e. The above drafts will be submitted to the panel of Department of Defense and Service representatives for review and for the following decisions:

(1) Will ASPR include a Section or Sub-section on the reporting of cost data for fixed-price type contracts or will this material be included in a revised Audit Manual?

(2) Action to be taken on Joint Letter #12?

(3) What vehicle is to be used to furnish information to contractors?



F. W. HESSER  
Rear Admiral SC USN  
FOR

WARREN WEBSTER, JR.  
DIRECTOR OF PROCUREMENT  
AND PRODUCTION POLICIES

10/17/54  
2nd issues  
functions  
6/17/54

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. Attached is the Subcommittee draft of a revised Part 2 of Section XV. As directed, in making this revision, all existing departmental papers having a bearing on this subject were considered. Part 2 has been revised to amplify the treatment of certain items of cost in the present Section XV, to assist in uniform departmental implementation, and to include coverage of additional items of cost incurred by Contractors. In this revision, each item of cost contains a definition, a statement as to the extent of allowability, unallowability, and whether provision must be made in the contract to make the item allowable.

2. Two issues have been raised in the development of Part 2 as follows:

(a) The Army Subcommittee members do not concur in paragraph 15-204.46(c) on education of individuals, but are willing for comments to be obtained on the present text.

(b) Should profit-sharing plans and stock-bonus plans be an unallowable item of cost as provided in paragraph 15-204.7 and by definition in 15-204.29? The Army and Air Force Subcommittee members believe that they should not be allowed and the paragraphs reflect their view. The Navy submits that they should be allowable. The two arguments on this question are also attached hereto.

3. While the Subcommittee members have developed the individual paragraphs of the Part, time has not permitted review of the draft as a whole in order to reconcile any possible inconsistencies.

4. The Subcommittee is now proceeding with the redrafting of Part 1. In addition, it is developing criteria or guide lines for use of contracting personnel which will set forth the limitation of and conditions under which those costs may be allowed which are not allowable unless specifically provided for in the contract in accordance with Part 2.

Lt. Col. J. M. Railing  
R. M. Kee  
J. T. Megardie (for E. T. Cook)  
A. C. Sawallisch  
Lt. Col. H. T. Critchlow  
Lt. Col. J. Ellis (for A. B. Thomas)  
H. H. Gallup

ARMY - AIR FORM

15 June 1951

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Part 53 of the Division of Section XX, ASPR Issues  
Relative to Whether or Not Part 2, Section XX,  
ASPR Shall Include Provision for Allowability  
of Costs of Profit-Sharing Plans and Stock Bonus  
Plans

1. An issue has developed among the members of the sub-  
committee as to whether or not profit-sharing plans and stock  
bonus plans shall be considered an allowable item of cost. The  
ASPR Committee members believe that contributions to such  
plans should not be considered as allowable costs under contract  
cost accounting contracts.

2. First, it is important to clearly distinguish between a  
"pension plan" and a "profit-sharing plan."

a. As defined under the regulations issued by the Com-  
missioner of Internal Revenue, the following is a description  
of a "pension plan", as set forth in regulations 118, Section  
39.165-1(a)(2):

"A pension plan within the meaning of section 165(a) is  
a plan established and maintained by an employer primarily to  
provide systematically for the payment of definitely deter-  
minable benefits to his employees over a period of years,  
usually for life, after retirement. Retirement benefits  
generally are measured by, and based on, such factors as  
years of service and compensation received by the employees.  
The determination of the amount of retirement benefits and  
the contributions to provide such benefits are not dependent

upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purpose of section 165(a), be considered a pension plan if under the plan either the benefits payable to the employee or the required contribution by the employer can be determined actuarially.

b. Also taken from Regulation 118, Section 39.165-1 (a)(2), immediately following the above, is the definition of a "profit-sharing plan":

"A profit-sharing plan, on the other hand, is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the



annual profits; (ii) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an overall limitation; or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation for each participant."

c. In summary, a pension plan is dependent upon an actuarial determination of either the employee benefits or the employer contributions. Consequently, the employer contributions are in the form of a fixed cost. Under a profit-sharing plan the employer contributions are contingent upon profits. Such profit-sharing benefits may be in the form of pension or retirement payments. Under the provisions 15-204.39 employer contributions to pension plans are allowable costs. However, in the opinion of the undersigned, employer contributions to profit-sharing plans should be unallowable.

3. The present regulations Part 6, Section XV, issued 1 March 1961, provides in subparagraph 15-601.2(f) that:

"Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to

contracts in any one year shall be the amount contributed to the pension trust (s) for that year but not to exceed fifteen (15) per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)." This subparagraph is inconsistent and contradictory in referring to cases "where pension or retirement plans are based on profits," since by definition (of the Internal Revenue Code) a pension plan is one in which "The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits". The current revision of Section XV, ASPR should provide clarity on this point by separate treatment of the two types of plans in conformity with the definitions given by the Internal Revenue Service.

4. The reasons for the position taken by the Army and Air Force representatives are as follows:

a. A business organization may make use of its earnings in many ways, such as,

- (1) Investments
- (2) Increase to working capital
- (3) Dividend payments to stockholders
- (4) Contributions to profit-sharing plans for employees

A distribution of earnings however accomplished cannot in equity be considered as a cost of performing a contract.

b. Under cost-reimbursement type contracts, the fixed fee negotiated is intended to represent the contractor's

entire profit. To allow contributions to profit-sharing plans as reimbursable costs is, in effect, giving the contractor an extra profit margin equal in amount to his contribution to the plan. If the contractor is, in fact, entitled to higher margins of profit, it should be through an increase in fixed fee rather than under the disguise of "costs".

5. With regard to stock bonus plans the Army and Air Force representatives consider that such bonus plans constitute a distribution of ownership or profits shared directly or indirectly by the other owners of the business. The cost of this distribution of ownership or profits is not a cost of production and therefore should not be allowed.

6. In essence, the issue in its simplest terms is whether any payments to employees (regardless of their form, such as bonuses, stock bonuses, deferred compensation or retirement trusts, etc., and regardless of the time, conditions or method of payment) which are contingent upon profits, present or future, should be excluded from allowable contract costs, however commendable or desirable the payments may be from the standpoint of efficiency or other business purpose. In conclusion our firm position is that such payments should not be recognized as allowable costs.

#### A R M Y

R. M. Kee, Army Audit Agency

Lt. Col. J. M. Railing, CS G-4

#### A I R F O R C E

Lt. Col. H. T. Critchlow, AFMPE

Lt. Col. J. E. Ellis, Jr. AFAUD

6/17/54

NAVY POSITION

Issue relative to whether Part 2, Section XV, ASPR shall include provision for allowability of costs of profit-sharing retirement plans.

1. An issue has been raised by the conferees of the subcommittee as to whether or not profit-sharing retirement plans shall be considered an allowable item of cost. Paragraph 15.601.2(f) of Part 6, Section XV states:

"Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year but not to exceed 15 per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)."

The Navy representatives see no reason for departing from the basic principle herein involved, that costs of profit-sharing retirement plans (subject to the restrictions embodied in Part 6, Section XV) are allowable. The Army and Air Force conferees are of other opinions.

2. The practical question faced by many businessmen is not whether to provide for the payment of retirement income to employees, but how to provide for it. A growing number of companies now realize that a deferred-distribution profit-sharing trust is an excellent way of financing retirement income for their employees. Unlike a formal pension plan which provides for fixed contributions year-in and year-out, profits or no profits, a profit-sharing plan provides for contributions when a company's earnings, if any, warrant such contributions. The plans providing for these contributions are subject to review and approval by the Internal Revenue Service prior to acceptance by the Military Departments, and are hedged with restrictions and limitations. The contributions under such plans are:

- (a) Paid into a trust
- (b) Irrevocable
- (c) Subject to qualifications and limitations of the agreement and the plans setting up the trust
- (d) For the exclusive benefit of the employees and of their beneficiaries
- (e) For the purpose of providing retirement income to their employees at a stated age, or at death or after termination of services or disability.

3. The issue here resolves itself around the term "profit-sharing". The Navy representatives are of the view that although this is a part of the terminology used, the fact remains that the contributions for the purposes

are no different in principle from contributions made for similar fringe benefits, such as pension costs. Almost 30% of the approximately 365 plans in the category of pension and profit-sharing retirement plans submitted to the Internal Revenue Service for the fiscal year ended 30 June 1953 were of a profit-sharing nature and the percentage is steadily increasing. Not to recognize the fact that profit-sharing is becoming an integral part of industrial operations is to overlook an important phase of industrial costs of operations.

4. The Navy conferees consider that a profit-sharing contribution is one which is measured or determined by the amount of a contractor's earnings. It is true that if there are no earnings, no contributions are made. However, it is considered by some that this is no different in principle from production workers piece-rate compensation and bonuses, or commissions paid to salesmen and others.

5. It should be pointed out that the contributions are irrevocably made to a trust fund and that the employees do not participate in the benefits (except as may be provided for in the plan at termination of service, disability or death) until the employees reach retirement age. One of the several requirements (all of which must be satisfied prior to approval of a plan by the Internal Revenue Service) is that the sole purpose of the trust is to provide benefits for the employees and their beneficiaries and that no part of the trust can revert to the employer.

6. A contribution to a profit-sharing trust is in the nature of compensation for personal services rendered by the covered employees and represents a necessary and ordinary business expense. Consequently it is provided that before a contractor may deduct contributions to a profit-sharing retirement plan, the requirements of the Internal Revenue Code as to reasonableness of compensation must be met.

7. To the extent that a contractor provides for reasonable fringe benefits, such as retirement, by one method or another, whether as a cost before determination of profits (as in the case of contributions under a pension trust) or after determination of profits appears to be immaterial provided the cost is reasonable and is in accord with the concept of a cost of doing business and other factors to be considered in determining allowability of costs. The mechanics of the method of computing the cost should not be the controlling criteria as to its allowability. The broader question to be considered is whether it is a necessary and ordinary business expense, which from a competitive standpoint other contractors provide for by different methods and yardsticks.

8. It is submitted that no business man will take the position that costs of profit-sharing retirement plans are not legitimate fringe benefits and consequently will provide for them in his costs of doing business.

9. While the above comments apply specifically to profit-sharing retirement plans, they also apply in principle to profit-sharing plans in general and stock bonus plans.

DRAFT 6/17/54  
SECTION XV SUBCOMMITTEE

15-200 SCOPE OF PART. This part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with commercial organizations and with non-profit institutions having commercial type accounting systems.

15-201 BASIC PRINCIPLES AND STANDARDS.

(a) Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

(b) Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations from the practices of the contractor prior to the award of the contract, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable.

(c) Credits. The applicable portion of income and other credits which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

(d) Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, this principle must be applied consistently to the costing of both defense and non-defense products or services, when the contractor is engaged in mixed production, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include

other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in the fairest and most equitable manner possible. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, the volume of sales, the volume of production, manufacturing



of the operation of cafeterias, dining rooms, canteens, lunch wagons or other type of food services, provided for the contractor's employees at their regular duty station. Such net costs are allowable when the services are reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement. Such net costs must be allocated to all contractor activities which benefit from the food service operation. Similarly any profit on these operations shall be allocated as a credit to all benefitted activities including Government contracts.

15-204.6 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of civil defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Contributions to local civil defense funds or projects not on the contractor's premises are ~~unallowable~~.

15-204.7 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee members.

Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees as a part of compensation is not allowable.

d. Special consideration will be accorded the following types of compensation benefits:

(1) Bonus plans. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are: (i) reasonable in amount, (ii) paid in connection with an established plan consistently followed by the contractor, (iii) paid for services currently rendered by the employee, (iv) available to all employees of the contractor, or to all employees within a group or salary classification which is not unreasonably restricted, bonuses will not be allowed when they are

ts of materials and supplies shall be suitably adjusted for  
 as of income and other credits. Such income and other credits  
 counts, refunds, rebates and allowances, cash discounts taken,  
 p and salvage and materials returned to vendors, and credits  
 ferences between book and physical inventories. If the contractor  
 se reasonable precautions in taking advantage of cash discounts  
 cash discounts lost may be deducted in determining allowable

ORGANIZATION EXPENSES. This item consists of expenditures in  
 th organization or reorganization of a business. Examples of such  
 corporation fee, attorneys fee, fees to promoters and organizers  
 raising capital. These costs are unallowable. (See also

OTHER BUSINESS EXPENSES. Included in this item are such recurring  
 s registry and transfer charges resulting from changes in ownership of  
 s, issued by the contractor, cost of shareholders' meetings, proxy  
 ions, preparation and publication of annual reports to shareholders,  
 ion and submission of required reports and forms to taxing and other  
 ry bodies and incidental costs of directors and committee meetings.  
 ve listed costs are allowable when incurred in reasonable amounts in  
 ance with the contractor's established practices and are allocated on an  
 ble basis to all classes of work. The above and similar costs are allow-  
 when incurred in reasonable amounts.

4.27 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item  
 lists of the premium portion of overtime and shift payments to employees.  
 premiums may be classified as either direct or indirect labor costs, but

the amount thereof should be separately identified in either event. When treated as direct labor cost, overtime and shift premiums should not be included in the base for distribution of overhead. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.28 PATENT EXPENSES. Included in this item are all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract are allowable when approved by the contracting officer. The cost of research and development work leading to patents is treated in subparagraph 15-204.37. These costs are unallowable except for the cost of preparing required disclosures and of preparing assignment and other papers in connection with the filing of a patent application for the Government. Charges for the use of patents where the Government has a license or the right to free use thereof are unallowable.

15-204.29 PENSION AND RETIREMENT PLANS

(a) As used herein, a pension or retirement plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance or survivorship benefits incidental and directly related to the retirement benefits. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and

Contributions to provide such benefits are not dependent upon profits. Benefits not definitely determinable if funds arising from forfeitures on termination of the plan or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries paid upon retirement or over a period of years after retirement will be considered a pension plan, if, under the plan, either the benefits payable to an employee or the required contributions by the contractor can be determined actuarially.

(b) Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure acceptance by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

(c) The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

(d) Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (Sec 15-204.7)

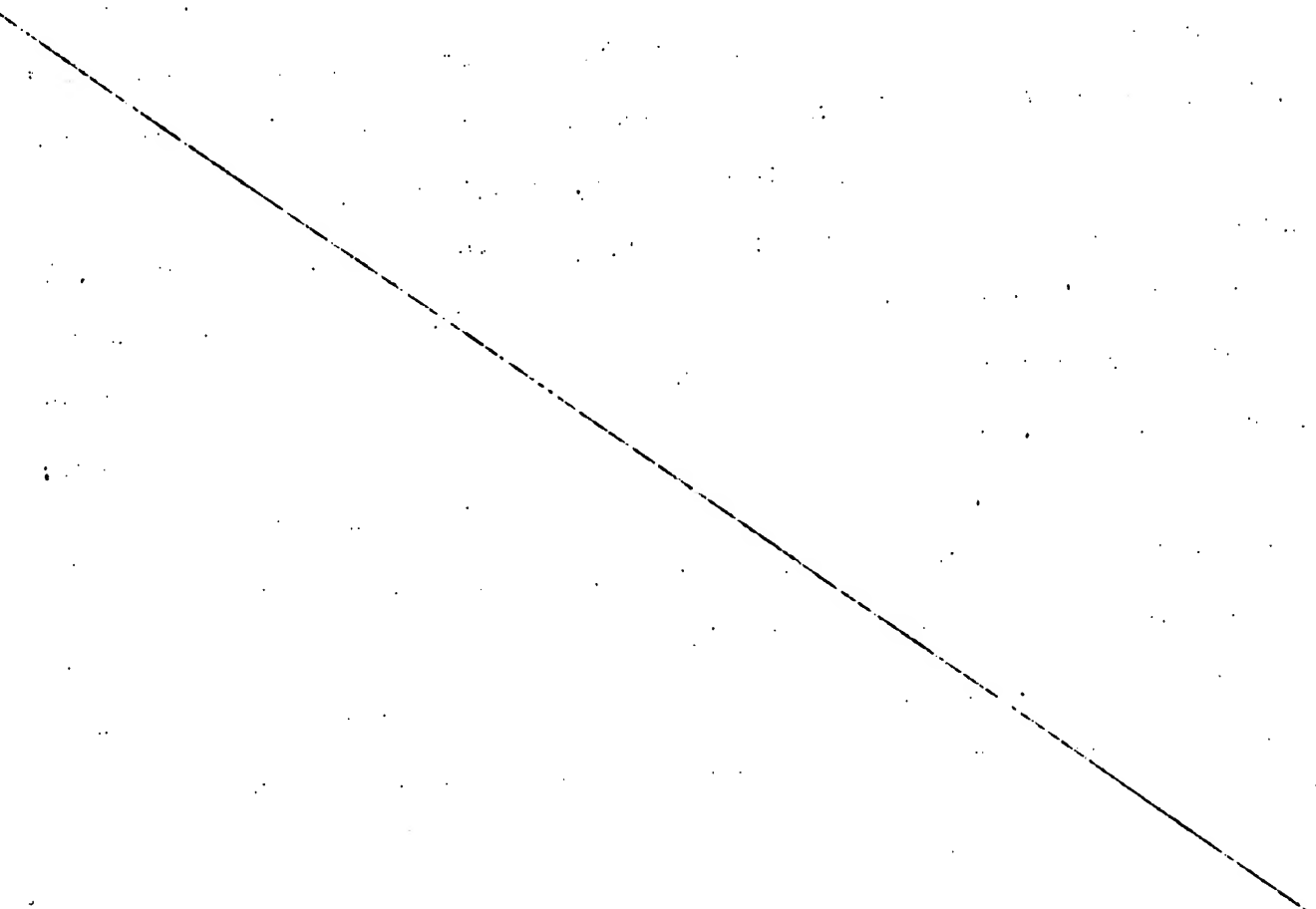
(e) The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

(f) Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, it will be expected that an arrangement will be made which will result, as nearly as may be practicable, in the Government's receiving the benefit of these credits to the same extent as it originally participated in the related costs. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount (of current pension costs) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future of a more accurate estimate can be made by virtue of experience which may be developed. Until such determination, current costs, which should be net of current credits, may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits. Such capture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass layoff of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

5-204.30. DELETED



15-204.31 PLANT PROTECTION EXPENSES. This item includes the cost of plant protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), burglar alarm systems, and fencing. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program at the specific direction of the contracting officer or other cognizant Government authority, are also allowable and allocable to specific Government contracts requiring special protection.

15-204.32 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

(a) This item includes the cost of professional services rendered, whether performed by the contractor's own employees or by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

(b) Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the contractor's business; (iii) the nature and scope of managerial services expected of the contractor's own organization; (iv) the nature of any conflict of interest which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship



to production under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(c) Professional services relating to patents are subject also to the limitations provided for in paragraph 15-204.28.

15-204.33 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.34 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property.

Reconversion expenses, except for the removal of Government property, are incurred for the benefit of future production and are, therefore, properly chargeable thereto. Accordingly, except for the cost of removing Government property and the restoration and rehabilitation costs caused by such removal which are specifically provided for in the contract, reconversion expenses are not allowable.

15-204.35 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an educational and aptitude testing program, travel expenses of employees

while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs incident to special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.36 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.)

This item includes expenses for (a) use of land, buildings, and equipment or other personal property, and (b) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities on long term leases.

(a) Rentals of plant and equipment under (a) above, if the rates are reasonable in light of the type, condition, and value of the facilities leased, options available, and maintenance on other provisions.

(b) Rentals specified in sale and lease-back agreements are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.37 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, (i) product research and/or development and (ii) general research.

(a) In the first category are included costs for design, improvement, and utilization of a particular product or product line. The allocable

portion of these costs are allowable under cost-reimbursement type production contracts where the research is reasonably related to the end items being purchased under the contract. These costs are allowable under cost-reimbursement type research and development contracts, only to the extent that such costs are directly chargeable to such contracts.

(b) In the second category, are included costs of all research other than that described in subparagraph (a) above. Reasonable costs of general research which are not otherwise reimbursed are allowable under cost-reimbursement type production contracts. Costs of general research are not allowable under cost-reimbursement type research and development contracts, unless specifically provided for in such contracts.

(c) Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract (including amounts capitalized in the costs of patents obtained) shall not be allocated to that contract.

15-204.38 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contract officer.

15-204.39 SELLING AND DISTRIBUTION EXPENSES. This group of expenses includes the costs of marketing, sales engineering, sales promotion, salesmen's and agents' compensation, and other related expenses. It also includes costs of advertising, bidding, outbound transportation, entertainment, service and

rental of facilities for meetings, and other incidental costs, when the primary purpose of the incurring of such expenses is the dissemination of technical information for the stimulation of production are allowable.

(c) All other entertainment expenses, including those classified as gratuities in accordance with paragraph 7-204.13, are unallowable.

15-204.13 Excess Facilities. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable unless specifically required by the terms of the contract.

15-204.14 Fidelity and Surety Bonds. The cost of bonds include net premiums paid for fidelity and surety bonds. Examples of such bonds are performance and payment bonds, forgery bonds, fidelity bonds, patent infringement bonds, etc. The cost of surety and fidelity bonds are allowable to the extent required by the contract or approved by the contracting officer both as to type and amount.

15-204.15 Fines and Penalties. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable. However, fines and penalties incurred due to situations in which the contractor has been instructed in writing by the Contracting Officer to follow a certain course of action, will be allowed.

15-204.16 Fringe Benefits

Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.29, 15-204.7, and 15-204.41 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.17 INITIAL PRODUCTION COSTS. Initial production costs, also known as "starting-load costs", are non-continuing costs that arise in early stages of production because of the Contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be disallowed.

15-204.18 INSURANCE AND INDEMNIFICATION

(a) Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and (2) those types of insurance which the contractor carries on his own account. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501. Examples of the kinds of insurance included in the second category are fire insurance on contractor-owned buildings and equipment, use and occupancy insurance, and employee fidelity bonds.

(b) Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. To the extent that any part of a contractor's insurance program has not been disapproved by the Military Departments, the costs of such other

insurance are allowable where the types of coverage, extent of coverage, and rates are reasonable under the circumstances; however, costs allowed for use and occupancy insurance will be limited so as to exclude coverage of profit, interest, federal income taxes, and unallowable selling and distribution expenses.

(c) Costs of insurance of any kind pertaining to Government-owned property for which the Government has assumed the risk of loss under the terms of the contract are not allowable. The cost of insurance covering contractor owned materials used or usable exclusively on work other than that required under the cost reimbursement type contract is not allowable under such contract.

(d) The costs of a self insurance program under which a contractor assumes its own insurable risks are allowable provided that (i) the program has been approved by the Military Departments and (ii) the hazards so insured against are not unusual or inconsistent with reasonable and prudent business practice, and (iii) the rates charged are estimated not to exceed available insurance rates for insurance as reduced by an amount equal to the acquisition expenses of the equivalent commercial insurance (commissions, fixed expenses, excess losses, etc.). Actual losses sustained under such a self-insurance program are not allowable.

(e) Insurance on the lives of officers, partners or proprietors, where the contractor is the beneficiary, is not an allowable cost.

(f) Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent business organization would have insured against such loss or damage, are not allowable.

(g) Costs of indemnification, in lieu of insurance, will be allowable only to the extent expressly provided for in the contract. By the term

(d) Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts taken, credits for scrap and salvage and materials returned to vendors, and credits arising from differences between book and physical inventories. If the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs.

15-204.25 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See also 15-204.19).

15-204.26 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above listed costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work. The above and similar costs are allowable when incurred in reasonable amounts.

15-204.27 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but



the amount thereof should be separately identified in either event. When treated as direct labor cost, overtime and shift premiums should not be included in the base for distribution of overhead. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.28 PATENT EXPENSES. Included in this item are all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract are allowable when approved by the contracting officer. The cost of research and development work leading to patents is treated in subparagraph 15-204.37. These costs are unallowable except for the cost of preparing required disclosures and of preparing assignment and other papers in connection with the filing of a patent application for the Government. Charges for the use of patents where the Government has a license or the right to free use thereof are unallowable.

15-204.29 PENSION AND RETIREMENT PLANS

(a) As used herein, a pension or retirement plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance or survivorship benefits incidental and directly related to the retirement benefits. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and

"indemnification" is meant Government assumption of losses arising from (i) lack of insurance coverage of risks of an insurable nature or (ii) restrictions on the amount of such insurance coverage.

15-204.19 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.26) These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.44.

15-204.20 LABOR RELATIONS. This item covers expenses incurred in maintaining the satisfactory relations between the contractor and his employees. It includes the costs of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.21 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development, or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.22 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation

basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

(b) Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract or an amendment thereto.

**15-204.23 MANUFACTURING AND PRODUCTION ENGINEERING.** Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefitted work.

**15-204.24 MATERIALS AND SUPPLIES.**

(a) This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor. Costs of materials and supplies

may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs (b) through (d) below.

(b) Any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. However, when materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, the contractor and the Government may agree upon the use of a different method of pricing based upon the fair value of the materials (but not in excess of replacement cost). Such agreement should include identification of the types or kinds of materials involved and should preferably be made at the time the contract is entered into and provided for therein.

(c) Ordinarily inter-company or inter-divisional sales or transfers of materials shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissible when the transactions involve items regularly manufactured and sold by an affiliate or division through commercial channels except as to items on which the Government is ultimately the sole user. In these latter cases, however, the price charged to the contract must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items. In other situations where consideration of the minority interest in an affiliate would warrant departure from the cost basis, such departure may be permitted but only if expressly authorized or approved by the contracting officer.

to production under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(c) Professional services relating to patents are subject also to the limitations provided for in paragraph 15-204.28.

15-204.33 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.34 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property.

Reconversion expenses, except for the removal of Government property, are incurred for the benefit of future production and are, therefore, properly chargeable thereto. Accordingly, except for the cost of removing Government property and the restoration and rehabilitation costs caused by such removal which are specifically provided for in the contract, reconversion expenses are not allowable.

15-204.35 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an educational and aptitude testing program, travel expenses of employees

while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs incident to special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.36 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.)

This item includes expenses for (a) use of land, buildings, and equipment or other personal property, and (b) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities on long term leases.

(a) Rentals of plant and equipment under (a) above, if the rates are reasonable in light of the type, condition, and value of the facilities leased, options available, and maintenance on other provisions.

(b) Rentals specified in sale and lease-back agreements are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.37 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, (i) product research and/or development and (ii) general research.

(a) In the first category are included costs for design, improvement, and utilization of a particular product or product line. The allocable

portion of these costs are allowable under cost-reimbursement type production contracts where the research is reasonably related to the end items being purchased under the contract. These costs are allowable under cost-reimbursement type research and development contracts, only to the extent that such costs are directly chargeable to such contracts.

(b) In the second category, are included costs of all research other than that described in subparagraph (a) above. Reasonable costs of general research which are not otherwise reimbursed are allowable under cost-reimbursement type production contracts. Costs of general research are not allowable under cost-reimbursement type research and development contracts, unless specifically provided for in such contracts.

(c) Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract (including amounts capitalized in the costs of patents obtained) shall not be allocated to that contract.

15-204.38 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contract officer.

15-204.39 SELLING AND DISTRIBUTION EXPENSES. This group of expenses includes the costs of marketing, sales engineering, sales promotion, salesmen's and agents' compensation, and other related expenses. It also includes costs of advertising, bidding, outbound transportation, entertainment, service and

warranty which are specifically covered elsewhere in this part.

(a) Generally, selling and distribution expenses are not allowable. However, there frequently are cases in which expenses in this group relate in whole or in part to contract negotiation and administration and technical, consulting, and other services of application and adaptation of products to the use and requirements of the Government. These costs are allowable when properly allocated.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost which violates the provisions of paragraph 7-203.20.

15-204.40. SERVICE AND WARRANTY EXPENSES. This item includes such costs as providing service in installation, training personnel in the use, operation and maintenance of the product, correcting defects in the product, replacing defective parts, refunds in case of inadequate performance and other related costs. Actual costs to be reimbursed to the contractor will include such of the fore-going costs as must be borne by the Government under the clause of the contract entitled "Inspection of Supplies and Correction of Defects" (See paragraph ASPR 7-203.5).

15-204.41 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.



For contract costing purposes severance pay is divided into two categories as follows:

(a) Normal Turnover Severance Pay. The cost of severance payments arising from normal severances should be allocated to all classes of work being performed in the contractor's plant at the time of payment. Where the contractor provides for ~~accrued~~ accrual of normal severance pay such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period.

(b) Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor is allowable. The amount allowable shall be determined by assigning the total cost to the period in which the severance pay was actually earned and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract must be made in the future.

15-204.42 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling

is acquired it shall be subject to the provisions of the contract clause set forth in paragraph 13-503 entitled "Government Property" and to the provisions of Appendix B, ASPA, applicable to government-owned special tooling. The cost of special tooling which is useful under both government contracts and other work of the contractor is allowable when properly allocated.

15-204.43 STRIKES AND LOCKOUTS, EXPENSES OF. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits.

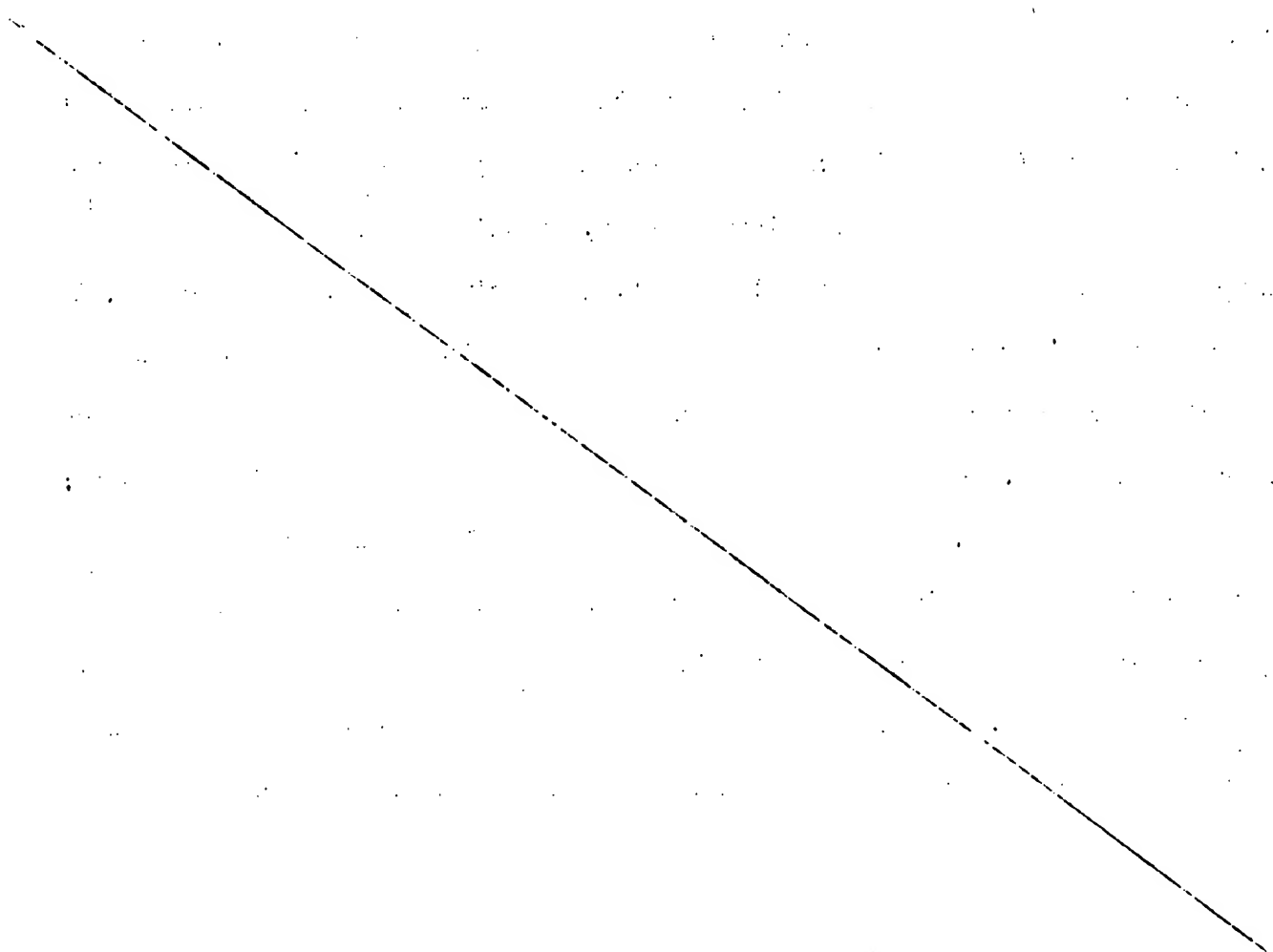
15-204.44 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.19); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits, may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass layoff of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-204.30. DELETED



(d) Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (Sec 15-204.7)

(e) The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

(f) Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, it will be expected that an arrangement will be made which will result, as nearly as may be practicable, in the Government's receiving the benefit of these credits to the same extent as it originally participated in the related costs. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount (of current pension costs) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

15-204.31 PLANT PROTECTION EXPENSES. This item includes the cost of plant protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), burglar alarm systems, and fencing. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program at the specific direction of the contracting officer or other cognizant Government authority, are also allowable and allocable to specific Government contracts requiring special protection.

15-204.32 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

(a) This item includes the cost of professional services rendered, whether performed by the contractor's own employees or by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

(b) Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the contractor's business; (iii) the nature and scope of managerial services expected of the contractor's own organization; (iv) the nature of any conflict of interest which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship

officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.45 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

(a) Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's production had been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one; is primarily for trade, business, or professional purposes; and membership would be expected of all similar business firms in the business community. The costs of social, cultural, or recreational activities of such organizations are not allowable.

(iii) If the organization is regional, national or international in scope, membership therein should be held by a majority of like firms in the same industry.

(iv) The costs must be reasonable. In determining reasonableness of particular membership costs which appear to be excessive, a review of the nature of the activities of the organization may be necessary in order to reduce the allowable portion of the contractor's membership costs to an amount which

would, in effect, exclude a contribution to lobbying or public relations activities.

(b) Subscriptions. This item includes the cost of subscriptions to <sup>which</sup> trade, business, professional, or technical periodicals or services/are allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-204.46 TRAINING EXPENSES.

(a) This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is conducted by the contractor; and tuition, fees, training materials and text books when the training is in educational institutions.

(b) Such costs which are limited to training for specific jobs in the plant are allowable when properly allocated.

(c) Such costs for educational advancement will not be allowed except in scientific engineering and technical fields related to the contractor's business, and then only if it can be established that the value thereof to the individual employee was equitably taken into account as a part of the total compensation of the employee. (See paragraph 15-204.7)

15-204.47 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be directed costed or added to the cost of such material. (See paragraph 15-204.24) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.48 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

(a) Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

(b) Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

(c) Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

(d) Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

(e) Entertainment expenses are not allowable.

(f) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

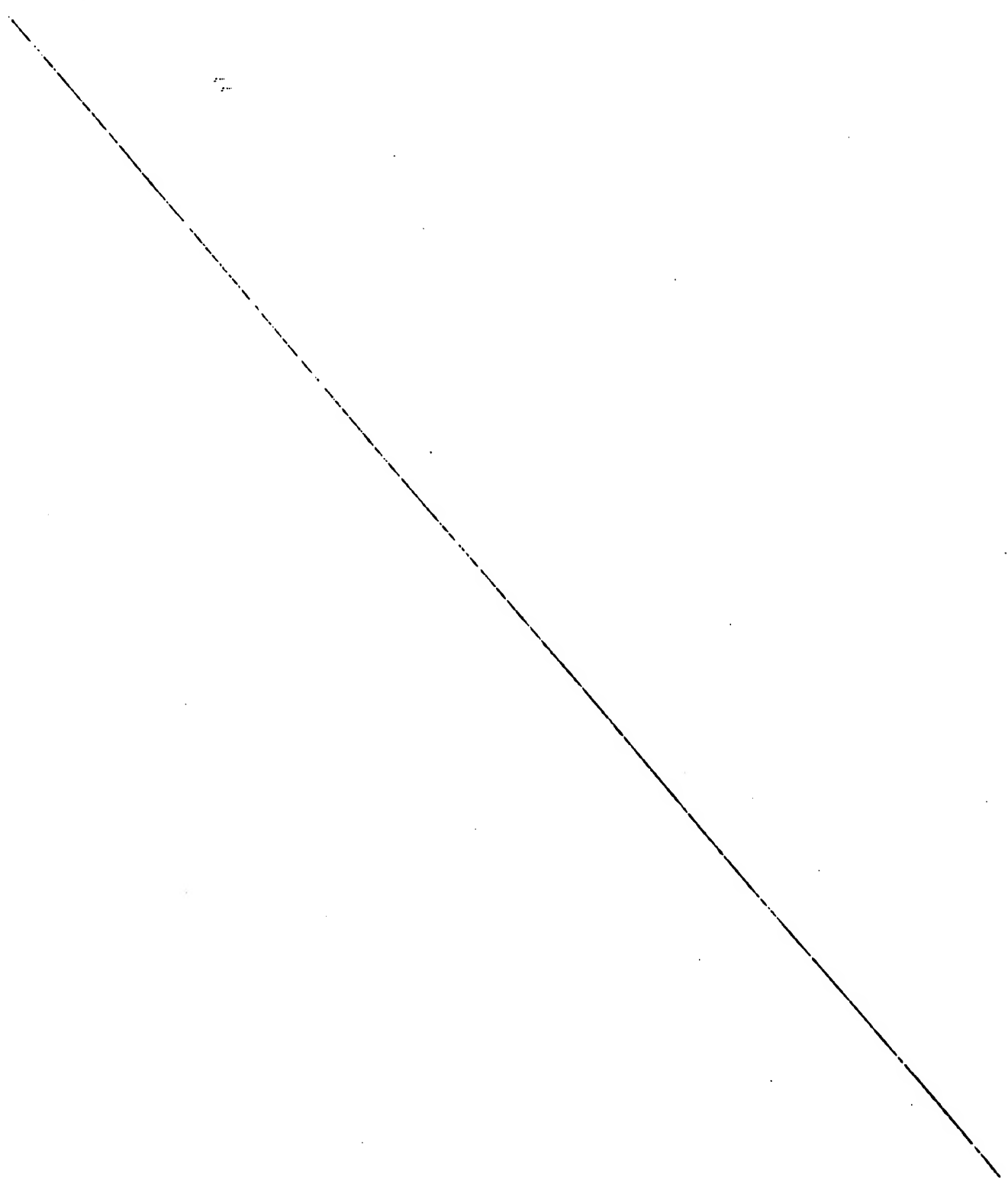
15-204.49 UNCLAIMED WAGES. Unclaimed wages are compensation earned but not claimed by employees normally represented by pay checks not presented for payment and liability to such employees or former employees for sums left over from amounts originally drawn for payrolls.

Unclaimed wages, previously reimbursed to contractor will be reviewed at intervals and particularly at the completion of the contract to determine what portion of these unclaimed wages shall accrue as a credit to the contract or subsequent refund to the Government.

Costs should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid



subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.



15-200 SCOPE OF PART. This part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with commercial organizations and with non-profit institutions having commercial type accounting systems.

15-201 BASIC PRINCIPLES AND STANDARDS.

(a) Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

(b) Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section IV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable.

(c) Credits. The applicable portion of income and other credits which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

(d) Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, it must be applied consistently to the costing of both defense and non-defense products or services, when the contractor is engaged in mixed production, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the con-

tract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in the fairest and most equitable manner possible. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as

direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering administrative expense and general supplies. These expenses arise out of engineering activities which include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods and related blueprinting and drafting.

Indirect engineering expenses should be allocated to the benefited activities, i.e., the contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars, or other equitable basis. NOTE: Direct costs of engineering activities should be charged directly to the benefited activities, i.e., the contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 INDIRECT SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be

allocable to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, in some instances, depending upon a showing of benefit to, or necessity for, the performance of the contract, some expenses which ordinarily are included in this group may be determined to constitute allowable costs. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the overall management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the generally recognized bases are as follows:

- (a) Total costs incurred (exclusive of general and administrative expenses, but including materials purchased).
- (b) Factory input (charges to work in process or equivalent accounts).
- (c) Cost of goods manufactured.
- (d) Processing costs (direct labor, plus direct and indirect production costs, exclusive of direct material).
- (e) Cost of sales.
- (f) Sales.

Among the factors that should receive consideration in determining whether the results are equitable are (1) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity

as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work.

The "total costs incurred" basis will usually result in an equitable distribution of expense where the cost elements which make up the base are representative of all activities which require general administrative and supervising effort. The "sales" basis is usually not equitable where there is a distorting profit factor and the concurrency of sales with production varies between Government and commercial products. In the evaluation of these and other methods, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

20 April 1954

**MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE**

**SUBJECT: Case 53-44 - Revision of Section XV**

1. In accordance with paragraph 6 of the ASPR minutes of 2/9/54, this Subcommittee has proceeded in the redrafting of Section XV.
2. The Subcommittee has rewritten and expanded the introductory material in Part 2 of the Section. A copy of this effort is attached. While considerable time has been expended in drafting this introductory material, it should be noted that much of it will appear in the introduction of subsequent Parts. Part 1 has been reserved since it is introductory and cannot be written properly until all other Parts have been revised.
3. Pursuant to the McNeil-Webster agreement of 3/1/54, the ASPR Committee and the Office of the Comptroller were directed to undertake certain work concurrently "with a sufficient interchange of ideas to incorporate all basic principles". This progress report is submitted so that the ASPR Committee can comply with the direction.
4. The Subcommittee is actively proceeding with the Section XV revision on a one-day-a-week meeting basis.

H. H. GALLUP  
Chairman  
Section XV Subcommittee



53-44

*1. 2. 3. 4. 5. 6. 7. 8. 9. 10. 11. 12. 13. 14. 15. 16. 17. 18. 19. 20. 21. 22. 23. 24. 25. 26. 27. 28. 29. 30. 31. 32. 33. 34. 35. 36. 37. 38. 39. 40. 41. 42. 43. 44. 45. 46. 47. 48. 49. 50. 51. 52. 53. 54. 55. 56. 57. 58. 59. 60. 61. 62. 63. 64. 65. 66. 67. 68. 69. 70. 71. 72. 73. 74. 75. 76. 77. 78. 79. 80. 81. 82. 83. 84. 85. 86. 87. 88. 89. 90. 91. 92. 93. 94. 95. 96. 97. 98. 99. 100.*

DEPARTMENT OF THE ARMY  
OFFICE OF THE ASSISTANT CHIEF OF STAFF, G-4, LOGISTICS  
WASHINGTON 25, D. C.

4 December 1953

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Proposed Section XV of ASPR, Draft dated November 1953

1. The undersigned members of the ASPR Section VIII Termination Subcommittee view with apprehension the far reaching effect of the proposed Section XV upon the area of terminations which, in our judgment and experience, has required special treatment that sets it apart from other elements of the procurement process. The Contract Settlement Act, the Joint Termination Regulation, and Section VIII of ASPR were all prepared along a broad background of Government purchasing but were devoted exclusively to the specialized field of termination. The preliminary examination which we have made of Section XV disturbs the Subcommittee in that the proposed new Section does not adequately cover the necessary provisions of the present Section VIII, Part 4.

2. At no time has the Section XV Subcommittee called upon the Termination Subcommittee for its views in connection with the substance of the proposed draft of Section XV, dated November 1953, as it affects Section VIII. Hence, the Section VIII Subcommittee feels it is necessary to request a reasonable period of time in which to prepare and present its objections to this draft.

Albert Alberi, Air Force  
Albert Kornblum, Navy  
Lt. Col. Brooks C. Preacher, Army  
*Brooks C. Preacher*  
BROOKS C. PREACHER, Lt. Col, GS  
Chairman, Section VIII, Subcommittee

*Returned to Subcom*  
*12/10/53*  
*MDC*

1 December 1953

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Parts 1, 2, 3 and 4 of Section XV

1. Attached are drafts of Parts 1, 2, 3 and 4 of Section XV which have been revised in the light of the comments received from the various echelons of the Military Departments.

2. Set forth below are the issues developed at Subcommittee meetings, which represent, except for Comment "I", the unanimous views of the Subcommittee versus those of the OSD Comptroller's representatives. The OSD Comptroller representatives will present their views separately. In those instances in which the Subcommittee recommends deletion in the attached text, the material in question has been bracketed [ ] so that it may be more quickly identified.

A. Para. 15-101(a) (See page 1501) - The Subcommittee recommends deletion of the second and third sentences.

The Subcommittee position is that the substance of these is not questioned, but their presence in this Regulation will unduly delay negotiations by inviting unnecessary requests from contractors for special treatment in the contract which might not otherwise occur or be required. Furthermore, utilization of specific contract provisions to cover unusual circumstances is standard procurement practice which obviates the necessity for reference to such practice in this Section.

B. Para. 15-101(b) (See page 1501) - The Subcommittee members believe that the text, in its present wording, requires that Part 2 of the proposed revision be incorporated in all cost-reimbursement type contracts. It is felt that this is inappropriate with respect to contracts with educational institutions in that subparagraph 15-202(e) of Part 2 has no application to contract costing with such institutions and would, therefore, create confusion and misunderstanding. It is believed that there should be a separate part of Section XV devoted entirely to costing of contracts with educational or other non-profit institutions which do not use commercial cost accounting systems. Wording which would serve to give effect to the foregoing is as follows:

"(b) Cost-Reimbursement Type Contracts. Cost estimates shall be developed and evaluated, and reimbursements to the contractor for costs incurred shall be determined, through the application of these cost principles and standards. In the case of prime contracts with commercial organizations, and with educational or other non-profit institutions which have commercial type cost accounting systems, Part 2 and Parts 3, 4 and 5 (as appropriate to the type of work called for by the contract) shall be incorporated therein by reference in each instance. In the case of contracts with educational or non-profit institutions, which do not have commercial type

cost accounting systems, Part 6 shall be incorporated therein by reference in each instance. All cost-reimbursement type subcontracts shall incorporate by reference the appropriate Part or Parts of these cost principles and standards, depending upon the nature of the work called for in the subcontract and the type of organization with which the subcontract is let. For the purpose of determining the appropriate Part or Parts to be incorporated by reference in cost-reimbursement type subcontracts the criteria herein outlined for cost-reimbursement type prime contracts will be applicable."

The above text contemplates assignment of Part 6 to Cost Principles and Standards dealing with educational or other non-profit institutions. These comments also apply to paragraph 15-101(c).

C. Para. 15-101(c) (See pages 1501, 1502) - This Subcommittee has previously submitted this issue for consideration on the substitution of a new paragraph (c) on page 1502 for the one in brackets proposed by OSD Comptroller. The substitute paragraph not in brackets is the position of the ASPR Committee on this issue.

D. Para. 15-102.3 (See page 1503) - The Subcommittee recommends deletion of the last sentence.

The Subcommittee position is that this statement is not appropriate for inclusion in cost principles as such and belongs more appropriately in Section III of ASPR.

E. Para. 15-105 (See pages 1505, 1506)

(1) It is recommended that the second and third sentences and the first word of the fourth sentence be deleted. (See page 1505.) The Subcommittee position is the same as for 15-102.3 above.

(2) The Subcommittee recommends deletion of the last sentence. (See page 1506.) The Subcommittee position is that this last sentence is an open invitation to contractors to conceal or withhold actual product costs in favor of presenting only product line costs where it is to their advantage to do so. ASPR 3-101 provides that procurement by negotiation

"will be made to the best advantage of the Government, price and other factors considered. Negotiation shall thereupon be conducted, by contracting officers and their negotiators with due attention being given to the following and any other appropriate factors:

(a) Comparison of prices quoted, and consideration of other prices for the same or similar supplies or services, with due regard to production costs."

The reference to "or similar supplies or services" in the above quotation from Section III is adequate without reiteration in Section XV, to permit use of product line costs when only such costs are available,

F. Para. 15-106 (See page 1506) - The Subcommittee recommends deletion of the last two sentences and paragraph references.

G. Para. 15-106 $\frac{1}{2}$  (See page 1506) - The Subcommittee recommends deletion of this entire paragraph.

H. Para. 15-110 and 15-111 (See pages 1508, 1509) - The wording of these paragraphs places undesirable restrictions on the operations of the military departments in the conduct of their business.

I. Para. 15-311.2(a) (See page 1513) - The Subcommittee recommends that an assignment be made to the Editing Subcommittee to develop a standard contract clause whereby the Government may exercise its option on the pricing of materials and inventories at the date of the contract in a manner consistent with this subparagraph.

The Subcommittee position is that its redraft has the desirable feature of emphasizing treatment of inter-company sales on the basis of cost to the transferor and of deemphasizing any interpretation which might result in the pyramiding of profits.

K. Para. 15-313.3(d) and (e) (See pages 1531, 1532) - The Subcommittee recommends that the bracketed material in these two paragraphs be deleted.

The Subcommittee position is that the material which it recommends for deletion would permit a contractor to elect the depreciation of assets on the basis of an appreciation in their value by reference to "current price levels by the use of a general price index." Such a concept is objected to for the following reasons: (i) it will result in an unwarranted additional cost in Government procurement, (ii) in periods of rising prices contractors will take the election of using current market index but will resist its use in periods of falling prices, (iii) a substantial administrative burden is created for contracting officers and auditors since current book values would never be static, and (iv) the concept is not generally recognized by the accounting profession.

L. Para. 15-313.9 (See pages 1537-1539) - The Subcommittee recommends the deletion of the bracketed paragraph proposed by OSD Comptroller and recommends adoption of the revised paragraph on page 1539 as drafted by the Subcommittee.

The Subcommittee position is that reconversion costs, except for the removal of Government property and restoration and rehabilitation costs caused by such removal, are incurred for the benefit of future production and as such should be properly charged only against future production and not against past production. This is considered to be in conformity with commercial practice in that reconversion costs are normally charged to the new line of business rather than the one being discontinued. As applied to Government contracts this means that we would pay the cost of converting the contractor's plant to our work but we would not pay for reconverting back to commercial work. It may be noted that at the end of WWII a definite stand was taken against allowance of these expenses - see the cost principles included in Appendix A of the Joint Termination Regulation which, under the category of excluded costs, reads as follows:

(b) The expenses of conversion of the contractor's facilities to uses other than the performance of the contract.

The Subcommittee very strongly feels that procurement should be accomplished on the basis of reasonable profits to contractors for the work that they perform in producing end products as being the contractor's entire consideration in entering into Government business as compared with remaining in commercial business and that the allowances for reconversion costs should not be used as an inducement to contractors to accept government business. Moreover, on the basis of past unsatisfactory experience, it is known that such costs may run to very substantial dollar amounts.

M. Para. 15-330.6 (See page 1559) - The Subcommittee recommends deletion of the bracketed material in this paragraph.

The Subcommittee recommends this deletion since it is believed to be inconsistent to recognize a cost policy for lower tier subcontractors which differs from that for prime contractors or their first tier subcontractors. Further, many cases exist where prime contractors are also sub and lower tier subcontractors.

3. Paragraph 15-350 (See pages 1563-1565) of the Revision contemplates the deletion of the existing text of ASPR 8-402 and the substitution of an appropriate cross-reference to the revised Section XV. It is recommended that the paragraph be reviewed by the Section VIII Committee.

4. Since the Subcommittee effort was directed principally toward the basic concepts of the proposals in accordance with the instructions of the ASPR Committee, the necessity for extensive editing is recognized.

J. H. Railing, Lt. Colonel  
R. H. Kee  
E. T. Cook  
A. C. Sawallisch  
H. T. Critchlow, Lt. Colonel  
A. B. Thomas  
H. H. Gallup, Chairman

SPR

16 October 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. This Subcommittee attended the ASPR Committee meeting on October 13, 1953 and was instructed (A) to revise the draft of 15-101(c) to state the use that will be made of Section XV by contracting officers in negotiating revised prices and (B) to draft a clause incorporating Section XV in price redetermination and incentive clauses.

2. With respect to problem (A), it is believed that the Subcommittee is in basic agreement with the intention of the use which will be made of Section XV by the contracting officer under redetermination and incentive clauses. The problem at the subcommittee level appears to be a choice of words to properly express that intention so that there will be no confusion in anyone's mind. It is not intended by incorporation to place a lever in the contractor's hands. It is contemplated that the members of this Subcommittee will be present at the meeting to express themselves on this matter. However, the Chairman of this Subcommittee in an attempt to clarify the problem believes that everyone agrees that it is intended that Section XV be used only as a yardstick in evaluating the contractor's cost estimates, and it is not intended to use it to establish the price. On the original draft the word "criteria" appears to avoid the confusing phrase "as a guide" which appears in the existing departmental instructions regarding the use of the present Section XV in redetermination proceedings. The Winston Dictionary defines the word "criterion" to mean "a standard by which a correct judgment can be formed, measure, test." Set forth below is a revision of para. 15-101(c) with three alternate second sentences:

"15-101(c) - Cost is but one of several factors to be considered in the negotiation of price or in negotiating settlements in the event of termination for the convenience of the Government.

Alternate (1) - When considering cost data as a basis for negotiation (as required by paragraphs 15-103 and 15-104) the cost principles or standards contained in this section shall be used as criteria for the evaluation of cost data submitted by contractors.

Alternate (2) - When considering cost data as a basis for negotiation (as required by paragraphs 15-103 and 15-104) cost principles and standards contained in this section shall be used as criteria to guide the commanding officer in the evaluation of cost data submitted by contractors.

Alternate (3) -When considering cost data in negotiations (as



required by paragraphs 15-103 and 15-104), the cost principles and standards contained in this section shall be used as criteria to guide the commanding officer in the evaluation of cost data submitted by contractors.

This applies to pre-award negotiations, negotiations during or upon completion of the contract, and negotiations in the event of termination for the convenience of the Government. Accordingly, Part 2 and either Part 3, 4, 5 or 6 (whichever is appropriate to the type of work called for by the contract) will be incorporated by reference in (i) the clause of every contract entitled termination for the convenience of the Government, and (ii) in all price redetermination and incentive clauses. Such incorporation shall further provide that such parts will be used as the basis for the development and submission of cost data by the contractor."

3. With respect to problem (B), Subcommittee drafted the following proposed provision establishing the proper tone for incorporation, recognizing that the placement of the provision in certain clauses will necessitate a proper introduction and revised wording. The clause agreed upon is as follows:

"Whenever cost data are required by this clause to be submitted by the contractor, the data submitted shall be developed in accordance with the cost principles and standards set forth in Parts 2 and of Section XV of the Armed Services Procurement Regulation hereby incorporated herein by reference for this purpose."

H. H. GALLUP  
Chairman, Subcommittee on  
Section XV, ASPR



1 October 1953

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-14 Revision of Section XV

1. Background - The Section XV Subcommittee is engaged in evaluating the comments of the various echelons of the Military Departments with respect to the drafts of Parts 1, 2 and 3 of Section XV. In this evaluation, a major issue of substance has been raised requiring resolution. This issue, together with a discussion thereof and the individual positions of the Subcommittee members and participants, is set forth below.

2. Issue - Should Section XV provide for the inclusion of the revised cost principles in contrast with provision for redetermination of the price or an incentive clause on a mandatory or optional basis?

3. Discussion - Paragraph 15-101(c), as circulated to the echelons for comment, provides for the mandatory inclusion of a reference to Section XV in all price redetermination and incentive clauses. The same paragraph provided that, when Section XV was incorporated in such clauses, the following would be applicable:

"Cost is but one of several factors to be considered in the negotiation of prices ..... In considering cost data as a basis for negotiation, the cost principles and standards contained in this Section shall be used as criteria for the evaluation of cost data submitted by contractors. . . ."

It was contemplated by the Subcommittee that an appropriate provision, incorporating the substance of the above quotation, would be developed for inclusion in all price redetermination and incentive clauses.

4. Subcommittee Positions -

a. Mandatory inclusion - Messrs. R. H. Kee, E. T. Cook, H. Wright, H. Maerker, and H. H. Gallup are for mandatory inclusion for the following reasons:

(1) Cost estimates submitted by contractors under price redetermination or incentive clauses are no different from cost estimates submitted in original pricing or contract termination, i.e. some formulae, guides, or criteria must exist to evaluate contractors' cost estimates. That is the sole purpose of the portion of paragraph 15-101(c) as set forth in the above discussion.

(2) To negotiate a redetermination type contract originally utilizing Section XV, then redetermining on no agreed basis, then subsequently terminating on the basis of Section XV results

in non-uniformity. The primary purpose of the revised cost principles was to have a uniform basis for the submission and evaluation of all cost estimates.

Lt. Col. J. M. Railing concurs with the mandatory view but reserves decision until the incorporation clause is developed.

b. Optional inclusion - Col. R. V. Raster, Lt. Col. H. T. Critchlow and Mr. A. C. Sawallisch advocate optional inclusion because:

(1) With respect to pricing, this philosophy tends to an overemphasis on cost, in lieu of price. Price is the important factor. Cost analysis, although a prime technique, is but one of many techniques or yardsticks available to a negotiator. It is considered that the mandatory feature of this draft will cause both Government negotiators and contractors to become preoccupied with costs to the detriment of sound pricing.

(2) The mandatory feature of these provisions can result only in prolonged negotiations. In the absence of explicit instructions as to what detailed information is to be furnished in cost estimates by prospective contractors (other than that such information must conform to the principles) misunderstandings will arise, and there will be a natural tendency on the part of negotiators to ask for more detail. Good vendor relations, however, dictate that information be obtained from prospective contractors with a minimum of discomfiture. More important, there will be demands from many contractors that specific items of cost be spelled out in fixed price contracts subject to price redetermination. Based on experience under Section XV as it applies to cost reimbursable contracts, it will take time to resolve many of the differences of opinion and interpretations that are bound to arise in this area.

(3) More emphasis will be placed on audits than heretofore by buying personnel in the pricing field. Overemphasis on audit is currently recognized as a difficult problem, and procurement and audit personnel of the Air Force have been attempting to minimize this problem. Heretofore, the negotiator had to be prepared to defend a price. As a result of this mandatory concept he will now have to defend in addition to the price the elements of cost comprising the price. To satisfy himself in this regard he must naturally rely more and more on audit.

5. It is requested that the ASPR Committee expedite consideration of this issue since it affects certain portions of Parts 2 and 3 of the Section which this Subcommittee is about to review.

H. H. GALLUP  
Chairman,  
Section XV Subcommittee

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply & Logistics

17 September 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

*Signed Copy*

SUBJECT: Case 53-44 - Revision of Section XV - Contract Cost Principles

I. PROBLEM:

To amend the report of the Patents Subcommittee on the subject material in memorandum dated 16 September 1953, in view of action by the ASPR Committee at its 15 September 1953 meeting, rejecting the Subcommittee's proposal for a paragraph 9-107.6 dealing with the problem of allowance of costs for support of contractors' programs for both product research and improvement and for general research.

II. RECOMMENDATION:

Referring to Tab A to the memorandum dated 16 September 1953, delete proposed revision of paragraph 15-313.11(c) and substitute the following:

"(c) See paragraph 9-107 for instructions as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or improvement."

III. DISCUSSION:

1. While the Patents Subcommittee report commenting on subject case is dated 16 September 1953, it had actually been completed and processed for reproduction on 14 September 1953. The report of 16 September 1953 was predicated on acceptance by the ASPR Committee of the proposal for a new paragraph 9-107.6 contained in Tab A to the Subcommittee's report on Case 52-77 - Revision of paragraph 9-107 - Second Proposed Revision of Section IX, contained in memorandum for the Chairman, ASPR Committee, dated 4 September 1953. When the last mentioned report was considered by the ASPR Committee at its meeting of 15 September 1953, paragraph 9-107.6 was rejected. It is therefore

necessary for the Patents Subcommittee to revise its proposal for paragraph 15-313.11(c) in its 16 September 1953 report to conform with the action by the ASPR Committee.

PATENTS SUBCOMMITTEE

BY:

*George W. Seevers*  
George W. Seevers (Navy)

*Jos. A. Hill*  
Jos. A. Hill, Capt. (Army)

*Frank D. O'Connell*  
Frank D. O'Connell (Air Force)

*Ray M. Harris*  
Ray M. Harris, Chairman (OSD)

16 Sept. 1953

## ASPR COMMITTEE

## PATENTS SUBCOMMITTEE

Case 53-44

## Proposed Revision of Section XV - Contract Cost Principles

## Proposed Revision of Proposed Paragraph 15-313.11

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15-313.11 Research and Development. Research and development expenses are incurred either as a result of work required in performing the contract or for programs of general research or product improvement maintained by the contractor, which programs are separate from and independent of the work which the contractor does for his customers under contract, and must therefore be supported by the contractor from his profits or personal funds, or by grants, or by charging to his customers as indirect costs in their contracts.

Product research or improvement is that effort which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. General research is all other research. In the event that product improvement is done under the name of general research or if there is confusion between or intermingling of general research and product improvement programs of a contractor, the total effort shall be regarded as product improvement.

The costs of programs for product research or improvement or for general research are subdivided into costs of conducting and performing the work under such programs and costs of administering such programs.

(a) Work Required Under the Contract. Research and development expenses required or approved by the contracting officer in performing the contract are allowable as direct costs.

(b) Costs of Programs. Costs of programs for product research or improvement or for general research are not allowable except as specified hereinbelow:

(i) The proper share of the indirect costs of administering programs for either product research or improvement or for general research is allocable to all classes of work, including Department of Defense contracts.

(ii) Costs of conducting and performing the work under product research or improvement programs are allowable in Department of Defense contracts for supplies or services but only to the extent that the work done under such programs is applicable to said supplies or services. Such costs may be allocated to DOD contracts with the following limitations:

(A) The costs are current, i. e., are incurred in the contractor's accounting period or periods during which the contract is performed.

(B) The costs are incurred in accordance with the contractor's established practice.

(C) The costs are not reimbursed to the contractor under separate contracts for research or development.

Such costs shall not be allowed in nor allocated to Department of Defense contracts for product research and development.

(iii) The cost of conducting or performing work under general research programs is allocable to all classes of work, including Department of Defense contracts, and may be allowed with the following limitations:

(A) The costs are current, i. e., are incurred in the Contractor's accounting period or periods during which the contract is performed.

(B) The costs are reasonable in amount.

(C) The costs are incurred in accordance with the Contractor's established practice.

(D) The costs are not reimbursed to the contractor under separate contracts for general research.

(E) The contractor's organization is not devoted primarily to research work, as distinct from manufacturing.

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply & Logistics

16 September 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

*Signed Copy*

SUBJECT: Case 53-44 - Revision of Section XV - Contract Cost Principles

I. PROBLEM:

To comment on proposed revision of Part 3, Section XV, dated 18 August 1953.

II. RECOMMENDATION:

A. The Patents Subcommittee recommends as follows:

1. In paragraph 15-313.11(a) and (b), change the term "product research and development" whenever it occurs to -- product research or improvement --.

2. That paragraph 15-313.11(c) be revised to read as shown in attached Tab A.

3. That paragraph 15-313.12 be revised as shown in Tab A.

B. The Patents Subcommittee attaches as Tab B, a re-write of paragraph 15-313.11(a) and (b) which it believes states more definitely the intent of this paragraph and which will avoid misinterpretation and misapplication of the paragraph.

III. DISCUSSION:

1. Reason for Recommendation 1 is that the term "product improvement" is believed to be in current usage to a much greater extent than "product development" for describing the situation to which the definition refers.

2. Revision of Paragraph 15-313.11(c) is recommended for the following reasons:

a. Cost allowances should not be dependent upon whether patent rights are obtained; rather, patent rights should be obtained whenever amounts for costs are allowed in sufficient quantity or proportion to justify an equitable division of patent rights developed with Government funds.



b. Patent rights should preferably be expressed in terms of a license to make or have made rather a waiver of royalties. The term "waiver of royalties" is generally thought of as applying to the following situations: (1) where the Government is purchasing from a licensee-manufacturer who pays royalties to the licensor patent owner, or (2) where the Government is itself a licensee under a royalty-bearing license. It is not customary, nor is it accounting policy, ever to allow patent royalties to the patent owner who is also making and selling the item covered by the patent.

c. The subject matter of subparagraph (c) is of substantive nature dealing with patent rights, and therefore should be in Section IX.

3. Change marked "W" in 15-313.12(b) is urged for the following reasons:

a. The statement that "Royalty costs may not be bona fide under the following circumstances" tends to imply that they are not bona fide in such situations, especially in view of the terminology used in describing the situations. It is believed that there should be no implication of a connection between bad faith and the circumstance, but rather a suggestion that the situation is one in which bad faith is more likely to occur.

b. There is no requirement in the language of the 18 August 1953 draft that the situation be reviewed or examined.

4. Change marked "X" presents third and fourth situations which are self-explanatory.

5. The recommendation for deletions from paragraph 15-313.12(b) of the matter designated as Change "Y" is for the reason that this provision with respect to reasonableness of the royalties in a bona fide agreement is basically unfair to the contractor. Notwithstanding the fact that the royalties are payable to the persons named in subparagraphs (b) (i) and (ii), the obligation to pay the royalties is a contractual one entered into by and between competent contracting parties. Therefore, while the Government because of its control of the situation might disallow the payment of the royalties to the contractor, as a cost in a cost-type contract or as an element of price in a negotiated fixed-price contract, the contractor must nevertheless pay the royalties. Disallowance by the Government of the royalties provides no relief to the contractor against his obligation to the licensor. He must therefore pay the royalties out of his profits or out of his separate funds. The Patents Subcommittee does not believe it is fair to ask the contractor to do this. There is no objection to the disallowance of the royalties if they are not bona fide, or if they are obviously unreasonable, on the ground that here the contractor is only being penalized for his own incompetence or attempted sham.

16 Sept. 1953

ASPR COMMITTEE  
PATENTS SUBCOMMITTEE

Case 53-44

Proposed Revision of Section XV - Contract Cost Principles

Proposed Revision of Proposed Paragraphs 15-313.11(c) and 15-313.12

(COMPOSITE DRAFT)15-313.11

~~(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.~~

(c) See paragraph 9-107 for instructions and an appropriate contract clause securing to the Government patent rights when there is allowed a cost, either direct or indirect, for product research or improvement or for general research.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.11.

6. There is also the objection to the matter proposed to be deleted in Change "Y" that the test as to the amount of the royalty charge which is to be allowed appears impossible of application. How would the amount which would be allowed to the contractor under the provisions of 15-313.11 if the patent were owned by him be determined? Paragraph 15-313.11 is related to costs of research or development work. What are the costs to this contractor of research or development work which he did not do and which he might not be equipped to do? Over what period of time are such costs to be considered? It should also be pointed out that there is no correlation between the costs of research and development work and the value of the patent produced under such work.

7. It is believed that change marked "Z" in paragraph 15-313.12(c) is more completely descriptive and more informative of the situations in which, or methods by which, the Government may have acquired patent rights than a mere reference to Section IX. Also Section IX does not begin to cover the situation.

PATENTS SUBCOMMITTEE

BY:

*George W. Seevers*  
George W. Seevers (Navy)

*Joseph A. Hill*  
Jos. A. Hill, Capt. (Army)

*Frank D. O'Connell*  
Frank D. O'Connell (Air Force)

*Ray M. Harris*  
Ray M. Harris, Chairman (OSD)

Attachments - 2

1. Tab A - Prop. Revs.
2. Tab B - Prop. Revs.

(b) Royalty costs are allowable if bona fide and reasonable.

Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of

C H A N G E W less than arm's length bargaining. Royalty costs may not be bona fide under should be reviewed for bona fides or reasonableness in the following circumstances situations:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

C H A N G E X (iii) Royalties are paid to unaffiliated persons, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded.

(iv) Royalties are paid under an agreement entered into after the award of the contract without the approval of the contracting officer.

C H A N G E Y In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents.

C Z ~~(See Section IX, ASPR)~~ The Government may have obtained a royalty free  
H license or title to patents as a result of contract clauses such as  
A contained in paragraphs 9-107 or 9-112 [9-112 is renumbered 9-108 in  
N the Second Proposed Revision of Section IX 7 as a result of settlement  
G of claims, as a result of the employer's right in employees' inventions  
E provided under E. O. 10096, as a result of a royalty adjustment settle-  
ment, or as a result of separate purchase or gift.

OFFICE OF THE SECRETARY OF DEFENSE  
Washington 25, D. C.

24 July 1953

*Cash*  
*53-44*

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Proposed Revision of Section XV

1. This Subcommittee is presently considering the basic concepts of Part 3 of subject Revision.

2. In reviewing paragraph 15-313.15 entitled Taxes, this Subcommittee took the position that questions concerning what taxes should be included in contract estimates and reimbursements are primarily technical questions of policy and law which do not fall within the departmental responsibilities of the Subcommittee members.

3. In view of the above, it is unanimously recommended that paragraph 15-313.15 be referred to the Tax Subcommittee for accelerated consideration of the basic concepts which should be included in the proposal for coordination purposes.

H. H. GALLUP  
Chairman  
Section XV Subcommittee

~~RESTRICTED~~

24 July 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards for (i) the determination of costs under contracts with a Department, and subcontracts thereunder, which provide for the determination of the historical (actual) cost of performance thereof and (ii) the preparation of estimates of cost used in the negotiation or administration of contracts with a Department, and of subcontracts thereunder subject to the review or approval of a Department.

15-001 Effective Date of Section. This Section shall be complied with on and after , 1953, although compliance is authorized from the date of its issuance.

PART I - INTRODUCTION

15-100 Scope of Part. This part sets forth instructions concerning the use of the contract cost principles and standards.

15-101 Applicability. The cost principles and standards set forth in Part 2 of this section, as implemented by Part 3, Part 4, Part 5, or Part 6 of this section (whichever implementing part is applicable) shall be followed in the preparation of all cost data used in the negotiation and administration of contracts with a Department and of subcontracts thereunder which are subject to the approval or review of a Department. In addition, and subject to the requirements of paragraph 15-104, these cost principles and standards shall be followed in determining cost under any contract with a Department, and any subcontract thereunder, which provides for the determination of the historical (actual) cost of performance thereof. Except as otherwise specifically provided, the same cost principles and standards of this section apply to the preparation of cost estimates as to the determination of historical (actual) costs. Nothing contained in this section shall be construed (i) as prohibiting the absorption by the Contractor of all or any portion of any element of cost or (ii) as requiring the allowance in the negotiation of contract prices all historical (actual) costs determined thereunder.

15-102 Use of Cost Estimates. In general, cost estimates shall be used in negotiating contracts, and modifications thereto affecting the contract consideration, unless other adequate valid pricing criteria exist. Though not necessarily adequate in any given situation, examples of such valid pricing criteria are:

~~RESTRICTED~~

**RESTRICTED**

1 July 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Section XV - Case 53-14

1. In accordance with item 19 of the minutes of the ASPR Committee meeting of 9 June 1953, this Subcommittee proceeded on an accelerated basis to consider Parts 1 and 2 of the Deputy Comptroller's proposal.
2. The Subcommittee's initial consideration of Parts 1 and 2 has been completed and attached is a Second Draft of these Parts. Agreement was reached with representatives of the Accounting Policy Division (OSD) except for the below listed additional changes which are unanimously recommended by the Subcommittee:
  - a. Delete paragraph 15-102. The explanatory material in this paragraph is more appropriate for inclusion in a preface, news release or some other media of publication. It is recognized that this paragraph may have some value for industrial coordination and if left in for this purpose, should be deleted prior to publication.
  - b. Revise paragraph 15-105. Revised paragraph should define which paragraphs of Parts I and II (in addition to subsequent parts) are appropriate for inclusion in contracts as "cost principles and standards." As an initial consideration, it would appear that all of Part I and paragraphs 203, 204, 205, 207, 208, 209, 212 and 213.1 are not appropriate for inclusion in specific contracts. This recommendation can be best accomplished by segregating into different Parts the paragraph to be incorporated in the contract and those of an administrative and informative nature.
  - c. Delete paragraphs 15-202(c) and 15-208. These references to the Internal Revenue Code should be eliminated since (i) the code was not designed for the determination of costs under contracts, (ii) the code is subject to constant change by laws, regulations, and court decisions, and (iii) ~~military contract negotiations and administration~~ personnel are not trained in the intricacies of the Internal Revenue Code.

**RESTRICTED**



~~RESTRICTED~~

- d. The last sentence of 15-203.3 and the second and third sentences of 15-204 concern selection of contract type and belong more appropriately in ASPR Section III. However, pending coverage of these subjects in Section III, there appears to be some justification for their inclusion here.
- e. Delete paragraph 15-207. This paragraph relates to profit policies and the ASPR Committee has appointed a Subcommittee to undertake the formulation of policies in this area. This paragraph has been revised for the benefit of that Subcommittee and it is recommended for referral thereto. Upon the adoption of a DOD policy, cross-reference thereto in this Section is recommended.

3. The Subcommittee did not consider that its assignment included coordination responsibility with other elements of the military departments. Attention is invited to the fact that the adoption of this Section would require the simultaneous adoption of a change in Section VIII. It is also recognized that editing is essential prior to publication.

4. Consideration of Part 3 of the proposal is being continued on a three meeting a week schedule and a final report will be submitted when the project is completed.

Lt. Col. J. M. Railing  
R. M. Kee  
E. T. Cook  
A. C. Sawallisch  
Lt. Col. H. T. Gritchlow  
A. B. Thomas  
Howard Wright  
Harry Maerker  
H. H. Gallup

~~RESTRICTED~~

TO: MR. *Thomas G. Cassidy*  
T. D. BLANCHARD

Subject: ASPR Case 53-44, Revision of Section XV  
Contract Cost Principles

In connection with ASBCA case No. 16445, Appeal of Control Data Corporation, I would like copies of the following documents (in Case 53-44 file).

- (a) Subcommittee Memorandum to the ASPR Committee dated November 1, 1955 including attached draft.
- (b) Editing Subcommittee Report of March 9, 1956 including attached draft.
- (c) American Institute of Accountants letter to Honorable Thomas P. Pike, dated 30 June 1955 including attached memo of Mr. M. E. Peloubet.
- (d) Excerpt from Committee <sup>minutes</sup> meeting of 14 August 1957 which records the Committee closing of ASPR case 53-44.

At your preference the copies can be submitted to me or to the ASBCA (Case No. 16445).

*OASD (IEL)  
Executive Secretary  
Armed Services Review Board  
Room 3D-780  
Pentagon*

DEC 3 1954

During the discussion of Revised Section 14V, the question was raised as to the effect of the new revenue legislation on depreciation costing. There follows a staff proposal on the subject.

Depreciation Cost Interpretation

15-602 Depreciation.

15-602.1 Effective Date and Applicability. This cost interpretation pertains to paragraph 15-204(d) and applies to payments made for depreciation incurred under all existing and future contracts in which the contractor's taxable year ends after 31 December 1953.

15-602.2 Interpretation. Any of the depreciation methods set forth in and as limited by Section 167 of the Internal Revenue Code of 1954 shall be recognized for contract cost purposes; provided, that depreciation is recorded on that basis in the contractor's books of account.

~~RESTRICTED~~

Second Draft  
1 July 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards to be applied uniformly (except as expressly qualified) in the determination of historical costs, the preparation and presentation of cost estimates by contractors, and the review, from a cost standpoint, of contractors' pricing proposals of those prime contracts and subcontracts which are subject to negotiation, approval or review within the Department of Defense as indicated in 15-103 and 15-104.

15-001 Effective Date of Section. This section shall be complied with on and after \_\_\_\_\_, 1953, although compliance is authorized from the date of its issuance.

PART 1 - APPLICABILITY AND PURPOSE

15-101 Applicability. These cost principles and standards are applicable wherever cost data are to be considered in the negotiation and administration of contracts. In connection with cost-type contracts, estimates of cost will be developed and evaluated and cost reimbursements to the contractor will be determined through the application of these cost principles and standards. Where price is to be negotiated, cost is but one of several factors to be considered in such negotiation. However, where cost data are used in negotiation, as required by this Section, such cost data will be developed and evaluated in accordance with the principles and standards contained herein.

15-102 Reasons for Issuance of This Statement. Defense procurement is a matter of great public interest. It is important that it be conducted on a plane that assures the Congress and the taxpaying public that defense materiel is being obtained at fair and reasonable prices without waste and extravagance. It is also important to assure defense manufacturers (especially competitors), of fair and equitable treatment, without discrimination, in contract pricing. A vast amount of defense materiel is obtained, especially in periods of emergency, under conditions where prices cannot be established simply by competitive bidding.

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The nature of the inherent risks in defense production, especially in the time-length of contract performance, and the frequent absence of complete product specifications, result in the use of various forms of contracts in which prices are determined to a greater-or-lesser degree by the use of cost data — both estimated and actual. The gathering, analysis, and use of cost data are complex problems, both for contractors and Government negotiators, as well as industrial and Government accountants and auditors who are more skilled in such matters. Cost problems are serious and diverse, both with respect to more basic business practices and to application of appropriate accounting principles. An adequate statement of cost principles and standards is necessary in order to avoid misunderstanding as well as confusion, delay, and expense in contract negotiation and administration, including auditing and settlement of contracts. Every defense contractor, therefore, should recognize the necessity of the adoption of these principles and standards in the common good — not merely for cost-reimbursement-type contracts, but also for other special types of contracts the use of which has greatly increased.

15-103 Use of Cost Estimates. The proper use of cost estimates requires the exercise of judgment and discrimination. It is impractical to lay down hard and fast rules which would be completely comprehensive in this area. In general, cost estimates shall be obtained from contractors in all cases except where other valid and adequate pricing criteria exist or the estimates would not materially assist the Contracting Officer in negotiating prices.

(a) Examples of valid, but not necessarily adequate in a particular case, pricing criteria to be considered for the purpose of determining whether cost estimates will be of material assistance include, but are not limited to, the following:

- (1) Competitive price proposals.
- (2) Published market prices.
- (3) Catalog prices, including discounts.
- (4) Previous procurement experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

(b) Examples of situations where cost estimates are ordinarily required are as follows:

- (1) Under outright fixed-price contracts when there is an absence of competition, prior experience or other valid pricing criteria.
- (2) Under fixed-price contracts containing price-redetermination provisions:

a. Negotiation of tentative initial prices.

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- b. Negotiation of firm prices on a forward basis.
- c. In combination with historical costs to arrive at firm prices for retroactive and prospective application. <sup>both</sup>

(3) Under incentive-type contracts:

- a. Negotiation of tentative target costs when firm targets cannot be initially determined.
- b. Negotiation of firm target prices and target costs, including those cases where the targets are set during the course of the contract.

(4) Under cost-reimbursement-type contracts:

- a. Initial estimates as a basis for establishing fixed fees.
- b. Negotiation of fixed overhead rates.

(5) Under all the above types of contracts for negotiation of:

- a. Contract price ceilings.
- b. Contract changes affecting the contract consideration.

15-104 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes:

(a) Under cost-reimbursement-type contracts:

- (1) Determination of allowable cost.
- (2) In combination with cost estimate to negotiate fixed overhead rates (where the contract provides for use of such rates)

(b) Under fixed-price contracts with retroactive price-retermination; negotiation of retroactive fixed-prices.

(c) Under incentive-type contracts: determination of final prices after contract completion.

(d) Under contracts terminated for the convenience of the Government: as required by Section VIII hereof.

In addition to the above listing of purposes for which use of historical cost is mandatory, such cost data may be useful in other circumstances and should be applied where appropriate.

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15-105 Contract Provisions. The principles and standards contained in this section shall be included directly or by reference in every cost-type contract to provide the basis for reimbursement to the contractor of costs incurred. Where a fixed-price-type contract requires or may involve future determinations of historical costs or the preparation of estimates of prospective costs (as specified in paragraphs 15-103 and 15-104) for purposes of negotiating contract prices, these principles and standards must be incorporated directly or by reference in the contract in order that no misunderstanding exist between the contracting parties as to the basis for a preparation and evaluation of cost data — estimated and historical. Inclusion of such contractual provisions in fixed-price-type contracts is solely for the purpose of preparation and evaluation of cost data which are not to be construed as rigid measures of a price to be negotiated. These principles and standards shall be thus made a part of every contract and subcontract whose costs are subject to the evaluation or review by the Department of Defense, or any of its subdivisions, executed as of a date on or after

, 1953. Any such contract or subcontract may treat any element of cost thereunder more specifically than provided by this statement of principles and standards so long as there is no inconsistency therein.

15-106 Implementation by the Military Departments. This statement of contract cost principles and standards shall be followed in procurement operations within the Department of Defense without modification or expansion in any way except as to instructions on administrative procedures or as provided in the last sentence of the preceding paragraph. Any expansion of or change in this section, deemed to be desirable, will be referred to the Office of the Secretary of Defense for consideration. Any interpretations of these principles and standards made in the course of negotiation or administration of contracts shall be on a case-by-case basis in the light of the specific facts thereof — no system of written interpretations to be generally followed will be permitted. Administration of these problems is a matter for practical business judgment rather than rigid adherence to established precedents.

15-107 Deviations. The authority to deviate, as provided in paragraph 1-108 of this Regulation, is further restricted in respect to this Section 15, to permit such deviations only on a specific contract basis.

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**PART 2 - GENERAL PRINCIPLES AND STANDARDS  
FOR DETERMINATION OF COSTS**

15-201 Composition of Total Cost. The <sup>total</sup>~~composition~~ of cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of (a) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (b) the properly allocable portion of allowable indirect costs, and (c) less applicable income and other credits. According to the circumstances involved, these costs may be stated either in terms of the aggregate for an entire contract or in terms of individual units of products or services covered by the contract with equal application of these principles and standards.

15-202 Factors Determining Allowability of Costs. Factors to be considered in determining the allowability of costs include (a) conformity with the meaning of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) allowability of the costs as deductions in determining taxable income under the Internal Revenue Code; (d) application of generally accepted accounting principles and practices; (e) avoidance of duplication of allowances for the same price component in both cost and profit; (f) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section; and (g) exercise of good business judgment in incurrence of the cost.

15-203 Actual and Estimated Costs. Costs used in negotiating contracts, or in making settlements thereunder, may be either of a historical nature (actual costs) or may be estimates of future costs, in whole or in part, whichever is appropriate for the specific type of contract pricing as indicated in paragraphs 15-103 and 15-104.

15-203.1 Applicability of Cost Principles to Determination of Cost Estimates as Well as Actual Costs. In general, the same cost principles apply to making cost estimates as to determination of actual costs. Therefore, this section will consider the cost principles set forth herein as applicable interchangeably to either cost estimates or actual costs, except as may be indicated specifically to the contrary.

15-203.2 Use of Standard Costs in Cost Estimates. Wherever future cost estimates are required, the use, where economically feasible, of modern standard cost methods should be encouraged, because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance

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of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

15-203.3 Use of Standard Costs in Determining Actual Costs. Wherever contract price negotiations or settlements depend upon actual costs, and contractors have satisfactory standard cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent actual costs, provided such costs reasonably reflect the application of the principles and standards set forth in this section. Normally, where adequate standard costs are available for complete end-products, fixed-price contracts should be used.

15-203.4 Use of Job-Order or Process Cost-Accounting Method. The use of either the job-order or process cost-accounting method in determining historical costs of contract performance is acceptable. In any pricing negotiations which require consideration of work in process at an intermediate point in the period of contract performance, special care must be exercised in order to segregate any part of the work in process costs which is not applicable to the completed portion to the cut-off point.

15-203.5 Use of Historical Costs for Purposes of Cost Estimating. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, may not provide a satisfactory standard of future performance; in this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-204 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in large volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing of such products. However, in those instances where cost analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not to impose impractical requirements on contractors for cost estimates — to meet which requirements might result in work entirely disproportionate to the amounts involved. Cost analyses in such cases may sometimes be based upon other data than current cost estimates — for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales,

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costs and profit data on a group of products, including the specific one subject to price negotiation.

15-205 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, it is desirable that definite understandings be reached between the contracting parties. This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be many occasions where specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles will be needed. (See paragraphs 15-105 and 15-106.)

15-206 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-207 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may be considered in determining either costs or profit (or fee). Major factors to be considered in this respect include prolonged delivery schedules, unstable market conditions for material or labor, or uncertainty as to cost of performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government assumes all the risk of cost increases or additional unknown costs, or a substantial share thereof (as it generally does when these risks are great) through the use of cost-reimbursement-type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for contingencies should be reduced to the extent appropriate. In negotiation of prices under outright fixed-price contracts, risks of loss or other cost increases, other than those reasonably certain and determinable, should be recognized in profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes.

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Where reasonably certain and determinable contingencies are recognized in cost estimates, such contingencies should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, in contracting for construction under cost-reimbursement-type contracts, it is customary practice to exclude general, administrative and financial expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-208 Relation of Contract Cost Principles to Federal Income Taxation. In general, all business costs allowable as deductions for the purpose of determining taxable income under the Internal Revenue Code should be allocated (assigned) to the extent appropriate, to the cost of performance of specific contracts, except as otherwise set forth in this statement of principles and standards.

15-209 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply and research contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, construction contracts and research and development contracts with non-profit institutions, Parts 4, 5, and 6 respectively, are devoted thereto.

15-210 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance -- for this reason, such allocated expenses are termed "indirect costs."

15-211 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to more than one class of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor must follow a consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

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15-212 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

- (a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;
- (b) Engineering expenses to extent not included in (a) or (c);
- (c) Selling and distribution expenses, incurred in marketing the products manufactured;
- (d) General and administrative expenses incurred in the overall management, supervision, and conduct of the business;
- (e) Financial and other expenses.

15-213 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. Any method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. ~~The best general test which may be applied to determine an appropriate method is to find the answer to the question: Does the method result in an allocation of the indirect costs to the products, job orders, or contracts, most equitably in relation to the machine or other work being performed on each?~~

15-213.1 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. This involves determination by the contractor of expense rates in accordance with whatever method or methods of expense allocation are followed. In accordance with the aim of encouraging the use of standard costs (paragraph 15-203.2), contractors should be encouraged to use accepted standard cost methods of budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses by cost centers in proportion to anticipated levels of production or work loads; such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

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(b) The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies in lieu of the determination of historical indirect expense is acceptable where mutually agreeable to the contracting parties provided there is reasonable assurance that the results would be equitable when compared with actual rates. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this Section concerning cost allowability and allocability. When predetermined expense rates are used the contract should specifically state the types of items which are to be treated as direct costs. The contractor must exclude from direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

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To Industry

11 April 1955

PROPOSED REVISION OF  
ASPR SECTION XV  
CONTRACT COST PRINCIPLES

The following letter and enclosure has been transmitted for comments to ten industrial associations representing a cross-section of Defense contractors.

The Department of Defense has had under development for some time through the Armed Services Procurement Regulation Committee, certain revisions to Section XV of the Regulation applicable to cost-reimbursement type contracts. Drafts of the proposed revision to Part 2 thereof are enclosed for your consideration and comments. Part 1 will contain only introductory rather than substantive material.

In the development of this draft serious effort has been made to amplify the treatment of certain items of cost in the present Section XV, to minimize the need for departmental implementation, and to include more equitable coverage of additional items of cost incurred by contractors. In this revision each item of cost contains a definition, a statement as to the extent of allowability, unallowability, and whether specific provisions must be made in the contract to make the item allowable.

We feel that this proposal has liberalized the treatment accorded certain controversial elements of cost and, in addition, has gone far in defining, delineating, and clarifying cost determinations under the Section in order to promote uniformity and minimize variations in its application. With respect to its application, or mis-application frequently complained of by industry, the recent issuance of Department of Defense Instruction No. 4105.11 specifically cancels an earlier Munitions Board Instruction permitting use of these Cost Principles as a "working guide" by Contracting Officers in the negotiation of prices under fixed price type contracts; this Instruction together with the statement of applicability presently contained in Part 1 of the Section should do much to satisfy the objections of mis-application.

It is requested that your comments or concurrence with respect to this proposed revision be forwarded to this office on or before 23 May 1955.

15-200 SCOPE OF PART. This part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, allowances, and equivalent benefits accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaried and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must



demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be states as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or mehtods. The objective should be the selection of a method or method which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering supervision, engineering administrative expense and engineering general supplies. These expenses arise out of engineering activities which include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods and related blueprinting and drafting.

Indirect engineering expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories

of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, determination as to allowability will be made in the light of the basic principles and standards and, where appropriate, the treatment of similar or related items in this Part. All of the subparagraphs below are subject to the basic principles and standards set out in paragraph 15-201.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

- (1) Advertising in trade and technical journals, provided such advertising does not offer specific products or services

for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry.

(2) Help wanted advertising, as set forth in paragraph 15-204.33.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, sales stores, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation from these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's

plant in which the services are furnished, except for services from which the profits are irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the bid location. Reasonable losses from operation from such services are allowable when it is determined that the contractor is intending to operate such services at no loss or profit. The gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When such services are intentionally furnished at a loss to the contractor, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of civil defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well

as fees paid to directors and committee members. Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

d. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(1) Paid pursuant to an arms length agreement between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect an implicit agreement on the part of the contractor.

(2) Reasonable in amount.

(3) Paid for current services actually rendered by employees.

(4) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably

restricted.

(5) Allowable as an ordinary or necessary business expense for tax purposes.

(6) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(7) Total employee compensation is reasonable in amount for such services.

e. Profit sharing plans.

(1) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation) which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(2) Except as provided in (3) below, the cost of profit-sharing plans shall be allowable under the following conditions:

(i) Compensation payable under immediate distribution plans is allowable subject to the criteria set forth in subparagraph d. above and g. below.

(ii) Employer contributions under deferred distribution profit-sharing plans, to be allowable costs, must meet all pertinent conditions set forth under subparagraph d. above and g. below and, if subject to Internal Revenue Service consideration, must have their approval. The carry-over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit-sharing plans shall not be recognized for Government contract cost determination purposes. Forfeitures of non-vested benefits under a profit-sharing plan will be treated in accordance with the principles stated in paragraph 15-204.27(f).



(3) Unless otherwise provided by special contract provision, the cost of profit-sharing plans shall not be allowable in the following situations:

(i) The business of the contractor at the time of entering into the contract is less than 75% with non-Governmental customers, taking into account the amount of the contract in question.

f. Stock bonus plans. Stock bonuses which are not disallowed by the provisions of subparagraph e. above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under sub-paragraph d. above and g. below and meet the following requirements:

(1) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(2) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(3) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(4) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

g. For the purpose of determination of reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall not exceed, in the aggregate for each participating employee, 15% of the total basic compensation paid or accrued to such employees in the year under consideration.

h. The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs 15-204.27, 15-204.43, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.16).

15-204.8 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established nonprofit charitable scientific and educational organizations are allowable provided that such costs are reasonable and are properly allocated to all work.

The propriety of the amount of particular contributions and donations and the aggregate thereof for each fiscal period must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular

contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for contract performance standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout

the life of the emergency facilities.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these activities will be credited to the costs thereof.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.27, 15-204.6 and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see sub-paragraph 204.16e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS. Initial production costs, known also as "starting-load costs", are non-continuing costs that arise in early stages of production because of the contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance.

15-204.16 INSURANCE AND INDEMNIFICATION

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by

specific instruction of the contracting officer or his authorized representative, and (2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. The costs of a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent

business organization would have insured against such loss or damage, are not allowable.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.40.

15-204.18 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting

principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefited work.



15-204.22 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b through f below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances. Cash discounts available, and credits for scrap and salvage and materials returned to vendors. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are equitable. Where materials in stock at the commencement date of the contract have a provable replacement cost significantly higher than book cost, the contractor and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should

include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. In the case of any item regularly manufactured and sold by any such transferor through commercial channels a departure from this cost basis is permissible, provided that the price charged to the contract does not exceed the lower of (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items.

15-204.23 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA P.M. SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See SPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.26 PATENT EXPENSES. Included in this item are amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. The cost of preparing disclosures as required by the contract and

of preparing assignment and other papers in connection with the filing of a patent application for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of patents where the Government has a license or the right to free use thereof, are unallowable. The cost of research and development work leading to patents is treated in subparagraph 15-204.35.

15-204.27 PENSION AND RETIREMENT PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance or survivorship benefits incidental and directly related to the pension benefits. Such benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of the plans will be the responsibility

of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. The cost of retirement plans, which are based on profit sharing, shall be subject to paragraph 15-204.6e. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered.  
(See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan, or the amount actually contributed, during the taxable year, whichever is the lesser. The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the

time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, it will be expected that an arrangement will be made which will result, as nearly as may be practicable, in the Government's receiving the benefit of these credits to the same extent as it originally participated in the related costs. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount of current pension costs negotiated and agreed upon in advance. Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans are allowable only to the extent specifically provided for in the contract.

15-204.28 PLANT PROTECTION EXPENSES. This item includes the cost of plant

protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), and depreciation on plant protection capital assets. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.

15-204.29 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the contractor's business; (iii) the nature and scope of managerial services expected of the contractor's own organization; and (iv) whether or not the proportion of Government work to the contractor's

total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation (except as provided for in 15-204.26), defense of anti-trust suits, and the prosecution of claims against the Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.32 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion expenses are not allowable except that the cost of removing Government property and the restoration costs caused by such removal are allowable if specifically provided for in the contract.

15-204.33 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating



an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.34 RENTALS OF PLANT AND EQUIPMENT (Including sale and leaseback of facilities.)

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Rentals specified in sale and lease-back agreements under (ii) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.35 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract

costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

(iii) The contractor agrees to divulge to the Government the results of such independent general research.

(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) with non-Governmental customers. If less than 75% at the time of entering the contract, allowance may be authorized by special contract provision.

The above conditions will also apply in the negotiation of predetermined overhead rates.

(2) Related research is that type of research which is directed toward practical application of science, and "development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (See 15-204.21). The costs of a contractor's independent related research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

15-204.37 SERVICE AND WARRANTY EXPENSES. This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASFR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor is allowable. The amount allowable shall be determined by assigning the total cost of actual mass severance payments to the entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property".

15-204.40 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.17); (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (iv) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred

by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

#### 15-204.41 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable,

b. Subscriptions. This item includes the cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

#### 15-204.42 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials

and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.43 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such material. (See paragraph 15-204.22). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.44. TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

e. Entertainment expenses are not allowable.

f. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.



March 9, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. In accordance with the request of the ASPR Committee (Minutes of Meeting of 28 February 1956, Item 12), the Editing Subcommittee met on March 2, 5, and 6, jointly with the Section XV Subcommittee and itself met in a further meeting on March 7, 1956.
2. The joint subcommittees discussed each of the areas referred to in paragraph 1 of the Editing Subcommittee report of February 27, 1956, and recommendations with respect to each area are set forth below under A, B, and C. The edited material prepared by the Editing Subcommittee as a result of such discussions is contained in the appropriately numbered paragraphs of the attached TAB B. The bracketed references are to paragraphs in the Section XV Subcommittee draft as submitted for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) [15-204.2lf]

The Problem:

In regard to transfers between divisions or organizations under common control of items not regularly manufactured and sold through commercial channels, the Editing Committee recommended that subparagraph 6 include the following words before the proviso:

"or the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lowest."

Joint Recommendation:

Do not include the words:

"or the cost to the transferor".

Include the words:

"or the prices of other suppliers for the same or substantially similar items, whichever is lower,"

B. Research and Development Costs - ASPR 15-204.2(v)(3) [15-204.34(ii)]

The Problem:

The Editing Subcommittee recommended that, in subparagraph 3, the term "product line" be clarified and that consideration be given to whether the proposed allocation of the costs of related research to "all production work of the contractor" would create an inequity since such costs would be allowable only to the extent the research was related to the "contract product or product line."

Joint Recommendation I:

Change the term "contract product or product line" to "contract product line." This was recognized as a temporary expedient which would probably have the effect of limiting the term "product line" so that it would not be construed as having the broadest possible application, i.e., all products sold by the contractor. There was general agreement that such a broad application was not intended and would be undesirable. However, a protracted discussion did not produce any general consensus of opinion on what area the term was intended to cover or what coverage would be desirable. The problem requires further study.

Joint Recommendation II:

The words "if allocated to all production work of the contractor" should be deleted to avoid an inequity and the following words should be added to the proviso before the period:

"and the costs are allocated to all production work of the contractor on the contract product line."

C. Pension Plans - ASPR 15-204.2(q) [ASPR 15-204.26]

I. The Substantive Issue Problem.

In regard to the issue relating to reversionary credits arising out of future abnormal terminations (discussed in paragraph 3.C.1. of the report of February 27, 1956), the Section XV Subcommittee was in agreement that its draft as submitted for editing was not intended to provide for retrospective accounting in addition to a discount of current costs or realistic recognition in the actuarial calculation of current costs in order to give effect to the anticipated future credits or gains arising out of "abnormal" terminations. Accordingly, it was

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

## II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.I., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the <sup>cases</sup>~~cases~~ of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

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Chairman

CHARLES W. WILKINSON  
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5 March 1956

AFMPP-PR-2

MEMORANDUM FOR ASPR EDITING AND SECTION XV PART 2 SUBCOMMITTEES

SUBJECT: Editing Subcommittee's Change to Paragraphs 15-204.21(f) and 15-204.34(b)(ii) Section XV Part 2 Cost Principles

1. The Air Force Procurement member of the Contract Cost Principles Subcommittee having given further consideration to the Editing Subcommittee's changes to (i) the material and supply paragraph relating to interdivisional transfer of such items and (ii) the paragraph on related research, finds he cannot agree to the changes considered by Section XV and Editing Subcommittees on 2 March 1956.

2. Consider first the edited changes to interdivisional transfer language, namely, the insertion of the words "or the prices of other suppliers for the same or substantially similar items, whichever is lower."

Reasons advanced for this addition were somewhat as follows:

a. "While it may not be likely to ordinarily occur, it is conceivable that a company might transfer goods from one division to another for use on a government contract at a 'price' based on existing market conditions which would be below the original cost to the transferor. Without this language the Government would be obligated to pay the transferor's cost, although the company might be willing to make the transfer at a price below cost".

Comment: Such a situation could only occur where such materials were in stock. The chances that this situation is ever likely to occur so that the contract costs would be affected in any material amount is so remote as to be beyond such serious consideration as to change the paragraph on interdivisional transfers. Companies just don't go about carrying large obsolete or non-usable materials in stock.

b. "This language would cover a situation where a contractor elects to manufacture in one of his other divisions an item which is not normally manufactured by that division, but which is regularly manufactured by another 'outside' company; and in such situation the change in the paragraph would limit the contractor's reimbursement for such item to the lower of his manufacturing cost or the price he would have paid had the item been bought from the normal outside manufacturer".

Comment: Again, this is a situation that is "conceivable" but its actual occurrence is so remote that it need not and should not be covered in the language relating to inter-

TAB A

divisional transfers. Such language can only lead to confusion among auditors, contracting officers and contractors as to how and when it applies. This type of situation can best be handled by the contracting officer in his approval authority over sub-contracts.

3. The change to the paragraph covering related research which would allocate to the contract the cost of its related research is, likewise, not agreed to.

4. The Contract Cost Principle Subcommittee, acting on instructions from the ASPR Committee, provided in its revision to the cost principles that related research related to the contract product line should be allocated to all production work of the contractor. This was based on the ASPR Committee's decision that a little more liberal treatment should be taken on accepting related research cost than the present existing ASPR 15-204(s) provides, which is: "Research and development specifically applicable to the supplies or services covered by the contract."

5. The Air Force Procurement member feels that there should be no change in the allocation to all production work of related research related to the contract product line.

PAUL M. SOUTHWELL

March 9, 1956

Part 2 -- Supply Contracts, and Service and Research  
and Development Contracts with Organizations  
Having Commercial Type Accounting Systems

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations from the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations set forth in this Part 2 or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-201.4 Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records" clause (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily



identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

### 15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

- (i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;
- (ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;
- (iii) any significant variations of inventories between accounting periods;
- (iv) variations in the ratio of the contract inventory levels to all other inventory levels; and
- (v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. Only the following advertising costs are allowable:

(i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and

(ii) help wanted advertising, as set forth in (t) below.

(b) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(c) Cafeteria, Dining Room, and Other Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a

concessionaire, shall be treated as a credit to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. Reasonable costs of civil defense measures, including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. Costs of capital assets acquired for civil defense purposes shall be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness of the amount of particular contributions and donations, and the aggregate thereof for each fiscal period, must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for standby purposes.

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d)). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(k) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and his employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(2) Costs of maintenance and repair which are delayed from a period prior to the contract, for some reason such as abnormal operating conditions or lack of funds, and are performed during the contract period are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

- (i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and
- (ii) current production problems, such as materials analysis for production suitability and component design for purposes



of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof shall be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of material if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed either (i) the transferor's sales price to its most favored customer for the

same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs in connection with the filing of a patent application by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be

paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of:

- (i) contractors who are subject to Federal income tax; and
- (ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) such costs shall meet the requirements of ASPR 15-201.2;
- (ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —
  - (A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, such costs could have been claimed and deducted for Federal income tax purposes in the current taxable period if such organizations were subject to the payment of income tax;

- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —
  - (A) disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax exempt organizations, could have been disallowed for tax purposes if such organizations were subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
  - (A) when such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or
  - (B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

retrospective accounting and any necessary adjustment for such subsequent termination credits unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(r) Plant Protection Costs. Costs of wages, uniforms, and equipment of personnel engaged in plant protection; supplies; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(s) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession separately engaged by the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

(i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;

- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organization; and
- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(u) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of the type, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne

by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

- (i) scope, nature, and quality of the contractor's independent general research program;
- (ii) capability of the contractor in the particular research field;
- (iii) benefits which may accrue to the Government;
- (iv) comparison of size and cost of contractor's previous years' independent research programs; and
- (v) proportion of Government business to contractor's total business.

(3) Related research is that type of research which is directed toward practical application of science. "Development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see ASPR 15-204.2(m)). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract, provided the research is related to the contract product

line and the costs are allocated to all production work of the contractor on the contract product line. Such research costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the research work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs are unallowable unless expressly set forth in the contract.

(x) Service and Installation Costs. Costs of servicing the product installation, and training Government personnel in the use, maintenance, and operation of the product are allowable.

(y) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) For contract costing purposes, severance pay is divided into two categories as follows:

(i) Costs of normal turnover severance payments shall be allocated to all classes of work being performed in the contractor's plant at the time of payment; however, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period; and



- (ii) costs of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of employment with the contractor and equitably allocated to all business of the contractor performed during that period. A reservation in the final release of claims (see ASPR 7-203.4) may be made in case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(z) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling, acquired for the performance of Government contracts, are allowable and shall be charged directly to such contracts.

(aa) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor, prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes;
- (ii) agrees to comply with such instructions; and
- (iii) agrees to take all necessary action directed by the contracting officer in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon.

Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are allowable. Reasonable costs of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest, or penalties for the benefit of the Government are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

(bb) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(cc) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text

books, and tuition and fees when the training is conducted by educational institutions, are allowable when limited to on the job training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided in the contract.

(dd) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items (see (n) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(ee) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Travel costs directly attributable to contract performance may be charged directly to the contract.

(4) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(5) Entertainment costs are unallowable.

(6) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ff) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and

forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

- (i) ASPR 15-204.3(e);
- (ii) ASPR 15-204.3(i); and
- (iii) ASPR 15-204.3(k).

#### 15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 204.2(j).)

(c) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable.

(d) Excess Facility Costs. Costs of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(e) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(f) Interest and Other financial Costs. Interest (however represented), bond discounts and costs, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus,

costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(aa) (but see ASPR 15-204.2(ff)).

(g) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(h) Organization Costs. Expenditures in connection with organization or reorganization of a business, such as incorporation fees, attorneys fees, accountants fees, fees to promoters and organizers, and costs of raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-lxx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs.

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(l) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) ASPR 15-204.2(g)(3);
- (ii) ASPR 15-204.2(l)(1), last sentence;
- (iii) ASPR 15-204.2(s)(3), first sentence;

- (iv) ASPR 15-204.2(t), last sentence;
- (v) ASPR 15-204.2(w); first proviso;
- (vi) ASPR 15-204.2(aa)(1)(i) through (iv); and
- (vii) ASPR 15-204.2(ee)(5)

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) ASPR 15-204.2(c), last sentence;
- (ii) ASPR 15-204.2(d), last sentence;
- (iii) ASPR 15-204.2(g)(5);
- (iv) ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
- (v) ASPR 15-204.2(l)(2);
- (vi) ASPR 15-204.2(o), second sentence;
- (vii) ASPR 15-204.2(p), second sentence;
- (viii) ASPR 15-204.2(s)(3), last sentence;
- (ix) ASPR 15-204.2(u)(2);
- (x) ASPR 15-204.2(w);
- (xi) ASPR 15-204.2(aa)(2);
- (xii) ASPR 15-204.2(cc), last sentence; and
- (xiii) ASPR 15-204.2(ee)(6)

NO. 31-55  
53-44  
Folder #2  
Department of Defense Instruction

**Subject: Depreciation Methods Approved for Purpose of Contract Costing**

**I. PURPOSE**

The purpose of this instruction is to establish uniform policy guidance with regard to the acceptance in contract costing of the provisions of Section 167(b) of the Internal Revenue Code of 1954.

**II. APPLICABILITY**

The policy set forth below is applicable to the determination of depreciation allowances for periods subsequent to 31 December 1953.

**III. POLICY**

The policy of the Department of Defense shall be to accept for contract costing purposes the use of any of the depreciation methods set forth in Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness. Meeting this test may depend, in appropriate circumstances, upon whether: (1) the method used in the particular case has been accepted for tax purposes; and (2) the costing of defense contracts is on a basis consistent with the costing of the contractor's nondefense work.

**IV. EFFECTIVE DATE**

This instruction is effective from the date of its issuance.

**V. DISSEMINATION**

The Military Departments shall promulgate this instruction as soon as possible. Copies of the Departmental implementation pertaining to this instruction will be forwarded to the Assistant Secretary of Defense (Comptroller) for information within (30) days of the date of its issuance.

Assistant Secretary of Defense  
(Comptroller)

March 9, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. In accordance with the request of the ASPR Committee (Minutes of Meeting of 28 February 1956, Item 12), the Editing Subcommittee met on March 2, 5, and 6, jointly with the Section XV Subcommittee and itself met in a further meeting on March 7, 1956.
2. The joint subcommittees discussed each of the areas referred to in paragraph 1 of the Editing Subcommittee report of February 27, 1956, and recommendations with respect to each area are set forth below under A, B, and C. The edited material prepared by the Editing Subcommittee as a result of such discussions is contained in the appropriately numbered paragraphs of the attached TAB B. The bracketed references are to paragraphs in the Section XV Subcommittee draft as submitted for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) [15-204.2lf]

The Problem:

In regard to transfers between divisions or organizations under common control of items not regularly manufactured and sold through commercial channels, the Editing Committee recommended that subparagraph 6 include the following words before the proviso:

"or the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lowest."

Joint Recommendation:

Do not include the words:

"or the cost to the transferor".

Include the words:

"or the prices of other suppliers for the same or substantially similar items, whichever is lower,"



B. Research and Development Costs - ASPR 15-204.2(v)(3) [15-204.34(ii)]

The Problem:

The Editing Subcommittee recommended that, in subparagraph 3, the term "product line" be clarified and that consideration be given to whether the proposed allocation of the costs of related research to "all production work of the contractor" would create an inequity since such costs would be allowable only to the extent the research was related to the "contract product or product line."

Joint Recommendation I:

Change the term "contract product or product line" to "contract product line." This was recognized as a temporary expedient which would probably have the effect of limiting the term "product line" so that it would not be construed as having the broadest possible application, i.e., all products sold by the contractor. There was general agreement that such a broad application was not intended and would be undesirable. However, a protracted discussion did not produce any general consensus of opinion on what area the term was intended to cover or what coverage would be desirable. The problem requires further study.

Joint Recommendation II:

The words "if allocated to all production work of the contractor" should be deleted to avoid an inequity and the following words should be added to the proviso before the period:

"and the costs are allocated to all production work of the contractor on the contract product line."

C. Pension Plans - ASPR 15-204.2(q) [ASPR 15-204.26]

I. The Substantive Issue Problem.

In regard to the issue relating to reversionary credits arising out of future abnormal terminations (discussed in paragraph 3.C.1. of the report of February 27, 1956), the Section XV Subcommittee was in agreement that its draft as submitted for editing was not intended to provide for retrospective accounting in addition to a discount of current costs or realistic recognition in the actuarial calculation of current costs in order to give effect to the anticipated future credits or gains arising out of "abnormal" terminations. Accordingly, it was

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

## II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.I., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the <sup>cases</sup>~~cases~~ of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

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5 March 1956

AFMPP-PR-2

MEMORANDUM FOR ASPR EDITING AND SECTION XV PART 2 SUBCOMMITTEES

SUBJECT: Editing Subcommittee's Change to Paragraphs 15-204.21(f) and 15-204.34(b)(ii) Section XV Part 2 Cost Principles

1. The Air Force Procurement member of the Contract Cost Principles Subcommittee having given further consideration to the Editing Subcommittee's changes to (i) the material and supply paragraph relating to interdivisional transfer of such items and (ii) the paragraph on related research, finds he cannot agree to the changes considered by Section XV and Editing Subcommittees on 2 March 1956.

2. Consider first the edited changes to interdivisional transfer language, namely, the insertion of the words "or the prices of other suppliers for the same or substantially similar items, whichever is lower."

Reasons advanced for this addition were somewhat as follows:

a. "While it may not be likely to ordinarily occur, it is conceivable that a company might transfer goods from one division to another for use on a government contract at a 'price' based on existing market conditions which would be below the original cost to the transferor. Without this language the Government would be obligated to pay the transferor's cost, although the company might be willing to make the transfer at a price below cost".

Comment: Such a situation could only occur where such materials were in stock. The chances that this situation is ever likely to occur so that the contract costs would be affected in any material amount is so remote as to be beyond such serious consideration as to change the paragraph on interdivisional transfers. Companies just don't go about carrying large obsolete or non-usable materials in stock.

b. "This language would cover a situation where a contractor elects to manufacture in one of his other divisions an item which is not normally manufactured by that division, but which is regularly manufactured by another 'outside' company; and in such situation the change in the paragraph would limit the contractor's reimbursement for such item to the lower of his manufacturing cost or the price he would have paid had the item been bought from the normal outside manufacturer".

Comment: Again, this is a situation that is "conceivable" but its actual occurrence is so remote that it need not and should not be covered in the language relating to inter-

TAB A

divisional transfers. Such language can only lead to confusion among auditors, contracting officers and contractors as to how and when it applies. This type of situation can best be handled by the contracting officer in his approval authority over sub-contracts.

3. The change to the paragraph covering related research which would allocate to the contract the cost of its related research is, likewise, not agreed to.

4. The Contract Cost Principle Subcommittee, acting on instructions from the ASPR Committee, provided in its revision to the cost principles that related research related to the contract product line should be allocated to all production work of the contractor. This was based on the ASPR Committee's decision that a little more liberal treatment should be taken on accepting related research cost than the present existing ASPR 15-204(s) provides, which is: "Research and development specifically applicable to the supplies or services covered by the contract."

5. The Air Force Procurement member feels that there should be no change in the allocation to all production work of related research related to the contract product line.

PAUL M. SOUTHWELL

March 9, 1956

Part 2 -- Supply Contracts, and Service and Research  
and Development Contracts with Organizations  
Having Commercial Type Accounting Systems

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations from the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations set forth in this Part 2 or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-201.4 Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records" clause (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

#### 15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, be applied



consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

- (i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;
- (ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;
- (iii) any significant variations of inventories between accounting periods;
- (iv) variations in the ratio of the contract inventory levels to all other inventory levels; and
- (v) other relevant factors including those mentioned in ASPR 15-203.1(b).

#### 15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. Only the following advertising costs are allowable:

(i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and

(ii) help wanted advertising, as set forth in (t) below.

(b) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(c) Cafeteria, Dining Room, and Other Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a

concessionaire, shall be treated as a credit to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. Reasonable costs of civil defense measures, including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. Costs of capital assets acquired for civil defense purposes shall be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness of the amount of particular contributions and donations, and the aggregate thereof for each fiscal period, must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for standby purposes.

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d)). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(k) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and his employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(2) Costs of maintenance and repair which are delayed from a period prior to the contract, for some reason such as abnormal operating conditions or lack of funds, and are performed during the contract period are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

- (i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and
- (ii) current production problems, such as materials analysis for production suitability and component design for purposes

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof shall be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of material if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed either (i) the transferor's sales price to its most favored customer for the



same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs in connection with the filing of a patent application by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be

paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of:

- (i) contractors who are subject to Federal income tax; and
- (ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) such costs shall meet the requirements of ASPR 15-201.2;
- (ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —
  - (A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, such costs could have been claimed and deducted for Federal income tax purposes in the current taxable period if such organizations were subject to the payment of income tax;

- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —
  - (A) disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax exempt organizations, could have been disallowed for tax purposes if such organizations were subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
  - (A) when such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or
  - (B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

retrospective accounting and any necessary adjustment for such subsequent termination credits unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(r) Plant Protection Costs. Costs of wages, uniforms, and equipment of personnel engaged in plant protection; supplies; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(s) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession separately engaged by the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

(i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;

- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organization; and
- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(u) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of the type, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne

by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

- (i) scope, nature, and quality of the contractor's independent general research program;
- (ii) capability of the contractor in the particular research field;
- (iii) benefits which may accrue to the Government;
- (iv) comparison of size and cost of contractor's previous years' independent research programs; and
- (v) proportion of Government business to contractor's total business.

(3) Related research is that type of research which is directed toward practical application of science. "Development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see ASPR 15-204.2(m)). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract, provided the research is related to the contract product

line and the costs are allocated to all production work of the contractor on the contract product line. Such research costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the research work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs are unallowable unless expressly set forth in the contract.

(x) Service and Installation Costs. Costs of servicing the product installation, and training Government personnel in the use, maintenance, and operation of the product are allowable.

(y) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) For contract costing purposes, severance pay is divided into two categories as follows:

(i) Costs of normal turnover severance payments shall be allocated to all classes of work being performed in the contractor's plant at the time of payment; however, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period; and

- (ii) costs of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of employment with the contractor and equitably allocated to all business of the contractor performed during that period. A reservation in the final release of claims (see ASPR 7-203.4) may be made in case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(z) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling, acquired for the performance of Government contracts, are allowable and shall be charged directly to such contracts.

(aa) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.



(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor, prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes;
- (ii) agrees to comply with such instructions; and
- (iii) agrees to take all necessary action directed by the contracting officer in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon.

Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are allowable. Reasonable costs of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest, or penalties for the benefit of the Government are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

(bb) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(cc) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text

books, and tuition and fees when the training is conducted by educational institutions, are allowable when limited to on the job training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided in the contract.

(dd) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items (see (n) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(ee) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Travel costs directly attributable to contract performance may be charged directly to the contract.

(4) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(5) Entertainment costs are unallowable.

(6) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ff) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and

forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

- (i) ASPR 15-204.3(e);
- (ii) ASPR 15-204.3(i); and
- (iii) ASPR 15-204.3(k).

#### 15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 204.2(j).)

(c) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable.

(d) Excess Facility Costs. Costs of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(e) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(f) Interest and Other financial Costs. Interest (however represented), bond discounts and costs, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus,

costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(aa) (but see ASPR 15-204.2(ff)).

(g) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(h) Organization Costs. Expenditures in connection with organization or reorganization of a business, such as incorporation fees, attorneys fees, accountants fees, fees to promoters and organizers, and costs of raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-lxx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs.

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(l) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) ASPR 15-204.2(g)(3);
- (ii) ASPR 15-204.2(l)(1), last sentence;
- (iii) ASPR 15-204.2(s)(3), first sentence;

- (iv) ASPR 15-204.2(t), last sentence;
- (v) ASPR 15-204.2(w); first proviso;
- (vi) ASPR 15-204.2(aa)(1)(i) through (iv); and
- (vii) ASPR 15-204.2(ee)(5)

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) ASPR 15-204.2(c), last sentence;
- (ii) ASPR 15-204.2(d), last sentence;
- (iii) ASPR 15-204.2(g)(5);
- (iv) ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
- (v) ASPR 15-204.2(l)(2);
- (vi) ASPR 15-204.2(o), second sentence;
- (vii) ASPR 15-204.2(p), second sentence;
- (viii) ASPR 15-204.2(s)(3), last sentence;
- (ix) ASPR 15-204.2(u)(2);
- (x) ASPR 15-204.2(w);
- (xi) ASPR 15-204.2(aa)(2);
- (xii) ASPR 15-204.2(cc), last sentence; and
- (xiii) ASPR 15-204.2(ee)(6)

NO. 31-55  
53-44  
Folder #2  
Department of Defense Instruction

**Subject: Depreciation Methods Approved for Purpose of Contract Costing**

**I. PURPOSE**

The purpose of this instruction is to establish uniform policy guidance with regard to the acceptance in contract costing of the provisions of Section 167(b) of the Internal Revenue Code of 1954.

**II. APPLICABILITY**

The policy set forth below is applicable to the determination of depreciation allowances for periods subsequent to 31 December 1953.

**III. POLICY**

The policy of the Department of Defense shall be to accept for contract costing purposes the use of any of the depreciation methods set forth in Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness. Meeting this test may depend, in appropriate circumstances, upon whether: (1) the method used in the particular case has been accepted for tax purposes; and (2) the costing of defense contracts is on a basis consistent with the costing of the contractor's nondefense work.

**IV. EFFECTIVE DATE**

This instruction is effective from the date of its issuance.

**V. IMPLEMENTATION**

The Military Departments shall promulgate this instruction as soon as possible. Copies of the Departmental implementation pertaining to this instruction will be forwarded to the Assistant Secretary of Defense (Comptroller) for information within (30) days of the date of its issuance.

Assistant Secretary of Defense  
(Comptroller)

OFFICE OF THE ASSISTANT SECRETARY (DEFENSE)  
WASHINGTON 25, D. C.

Supply & Logistics

April 3, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Section IV, Part 2  
Profit Sharing  
Contributions and Donations  
General Research Costs

On 3/2/56, the Section IV Committee considered the attached memorandum for the record concerning the three specific areas mentioned in the above subject.

With respect to paragraphs 1 and 2 of the attachment concerning profit sharing, before taking any action the Subcommittee requests specific guidance of the ASPR Committee. However, as to paragraphs 1, 2a and 2b, it was noted that if these principles are approved, they should merely be referred to the Editing Committee. As to paragraph 2c, the general feeling of the Subcommittee was that no further paragraphs should be added to Compensation since "reasonableness" could be relied upon.

As to paragraph 3a concerning Contributions and Donations, the Subcommittee has no objections to the text.

Regarding paragraph 3b covering General Research, the Subcommittee prefers the treatment accorded in the edited draft dated 3/29/56, as modified by the Subcommittee report thereon.

H. H. GALLUP

Attachment

3/30/56

## MEMORANDUM FOR THE RECORD

SUBJECT: Profit Sharing Plans, Contributions and Donations, and General Research Costs.

1. At a meeting held 3/30/56 in the Office of the Assistant Secretary of Defense (S&L), it was determined that the proposed revision of Section XV ASPR on the subject of Compensation specifically include the following first paragraph:

"Compensation is allowable. (The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits, in accordance with paragraph \_\_\_\_\_, salaries, wages, royalties, license fees and bonuses.) (The total compensation of an individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered)".

2. In connection with the above, it was also determined that:

- a. The revision of Section XV on profit sharing will include the existing ASPR coverage of the subject to the maximum practicable extent, i.e., no specific use shall be made to such terms as "immediate distribution profit sharing plans", "deferred distribution profit sharing plans", or "profit sharing plans".
- b. The title "Pension and Retirement Benefits" be expanded to read "Pension, Retirement, and Deferred Compensation Benefits" and that the concept of 15-601.2(f) be retained therein with the minimum possible changes in language.
- c. In addition to the language quoted in paragraph 2 above, the subject of Compensation may include additional paragraphs.

3. It was determined that ASPR coverage on Contributions and Donations, and General Research be as follows:

- a. "Contributions and donations are unallowable".
- b. "Costs of research programs of a general nature are allowable only to the extent expressly provided for in the contract."



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

July 30, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV, Contract Cost Principles

In accordance with Item 7 of the ASPR Committee Minutes of 7/3/56, your Subcommittee considered the report of the Tax Subcommittee, dated 21 June 1956, as well as the three specific questions of the ASPR Committee set forth in the Minutes referred to above. With respect to the Tax Subcommittee report, the following comments are provided:

1. The ASPR Committee rejected the suggestion that the clause include a reference to taxes of "foreign" governments in subparagraph (1.) of the clause.

2. The suggested change in subparagraph (2) of the clause is rejected. Your Subcommittee believes that this subparagraph as originally written adequately covers the problem. With respect to allowance of "interest and penalties incurred ....in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor", a government administrative burden is added to determine fault or negligence on the part of the contractor in each case and the situation can be avoided by the contractor paying the tax under protest.

3. The suggested addition of a sentence to subparagraph (3) is concurred in. As to the three questions raised by the ASPR Committee, the following answers are set forth:

A. Under subparagraph (1) of the clause will Defense reimburse a contractor for taxes "accrued"?

Answer: Yes, provided accrual is adjusted to actual taxes paid. However, to clarify the point beyond question, your Subcommittee proposes that in subparagraph (1) of the clause the phrase "in accordance with generally accepted accounting principles" be deleted since it is merely repetitive of an over-all requirement set forth in paragraph 15-201.2 and that the following clarification be substituted "and adjusted to amounts actually paid".

B. Is the statement contained in subparagraph (a)(ii) sound?

Answer: Your Subcommittee is unable to find any errors or weaknesses in this subparagraph.

C. Should the new sentence added to subparagraph (3) be a proviso sentence?

Answer: Yes.

For reference there is attached a copy of para. 15-204.2(y) as now recommended by your Subcommittee.

1 Incl.

H. H. GALLUP

(v) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued and adjusted to amounts actually paid are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties

incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government, provided any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties.

15-200 SCOPE OF PART. This part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, allowances, and equivalent benefits accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allocable to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a demonstration of benefits to Government contracts, these costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any recognized basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition,

consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, determination as to allowability will be made in the light of the basic principles and standards and, where appropriate, the treatment of similar or related items in this Part. All of the subparagraphs below are subject to the basic principles and standards set out in paragraph 15-201.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) Advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry.

(2) Help wanted advertising, as set forth in paragraph 15-204.33.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.



demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-204.4 CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES. This class of expense consists of the cost, less revenue, of operating, or furnishing facilities for, cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of food services for the contractor's employees at their regular duty station. Losses from operation of such food services are allowable when the services are fairly priced and costed and reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement. The gains or losses from these food services must be appropriately allocated to all activities benefited including Government contracts except, however, where (1) the net proceeds are for the exclusive benefit of an employee welfare organization of the contractor, or (2) the food services are rendered for gain by private interests beyond the immediate control of the contractor. Under each of the above two exceptions, no part of the gains or losses will be allocable to the contract.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of civil defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. In the case of capital assets, acquired for civil defense purposes the costs

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering supervision, engineering administrative expense and general supplies. These expenses arise out of engineering activities which include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods and related blueprinting and drafting.

Indirect engineering expenses should be allocated to the benefited activities, i.e., the contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime premium), or other equitable basis. NOTE: Direct costs of engineering activities should be charged directly to the benefited activities, i.e., the contract and other work of the contractor in accordance with paragraph 15-202.

thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee members. Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees is not allowable.

d. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(1.) Paid pursuant to an arms length agreement between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect, an implicit agreement on the part of the contractor.

(2.) Reasonable in amount. For the purpose of determination of reasonableness the employer contribution shall not exceed 15% of the total basic compensation paid or accrued to the participating employees in that year under consideration.

(3.) Paid for current services actually rendered by employees.

(4.) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(5.) Allowable as an ordinary or necessary business expense for tax purposes.

(6.) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(7.) Total employee compensation, including such profit sharing distribution, is reasonable in amount for such services.

e. Profit sharing plans. These plans provide for additional compensation and are based on or measured by contractor's earnings. These plans fall into two categories, immediate distribution and deferred distribution plans.

(1.) Compensation payable under immediate distribution plans is allowable subject to the criteria set forth in subparagraph d. above.

(2.) Employer contributions under deferred distribution profit-sharing plans, to be allowable costs, must meet all pertinent conditions set

forth under subparagraph d. above and, if subject to Internal Revenue Service consideration, must have their approval. The carry-over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit-sharing plans shall not be recognized for Government contract cost determination purposes. Forfeitures of non-vested benefits under a profit-sharing plan will be treated in accordance with the principles stated in paragraph 15-204.29(f).

f. Stock bonus plans. Bonuses of this nature may or may not be measured by profits. When stock bonuses are considered to be a form of compensation, the amount allowable for the contractor's cost in connection therewith shall be subject to all conditions pertinent under paragraph d. above and meet the following requirements:

(1.) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(2.) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(3.) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(4.) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

g. The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi shift premiums and other fringe benefits will be in accordance with paragraphs

15-204.27, 15-204.43, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this Part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening.

These costs are not allowable. (For self-insurance programs see paragraph 15-204.14)

15-204.8 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established nonprofit charitable organizations are allowable provided that such costs are reasonable and properly allocable to Government contracts.

The propriety of the amount of particular contributions and donations and the aggregate thereof for each fiscal period must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by

consistent application of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for contract performance standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Allowances for depreciation on emergency facilities will normally be determined in accordance with subparagraphs a. through d. above. However, where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of



working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these activities will be credited to the costs thereof.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable. However, fines and penalties, including interest thereon, incurred due to situations in which the contractor has been instructed in writing by the Contracting Officer to follow a certain course of action, will be allowed.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.27, 15-204.6, and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS. Initial production costs, also known as "starting-load costs", are non-continuing costs that arise in early stages of production because of the Contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be disallowed.

15-204.16 INSURANCE AND INDEMNIFICATION

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by

specific instruction of the contracting officer or his authorized representative, and (2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and unallowable selling and distribution expenses.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. The costs of a self insurance program are allowable provided the program has been approved by the Military Departments. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee group plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent

business organization would have insured against such loss or damage, are not allowable.

g. Costs of indemnification, in lieu of insurance, will be allowable only to the extent expressly provided for in the contract. By the term "indemnification" is meant Government assumption of losses arising from (i) lack of insurance coverage of risks of an insurable nature or (ii) restrictions on the amount of such insurance coverage.

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24) These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.41.

15-204.18 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the costs of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development, or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary

for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefitted work.

15-204.22 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b. through e. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, and credits for scrap and salvage and materials returned to vendors. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. Reasonable charges arising from differences between periodic physical inventory quantities and related material-control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between Periodic physical inventory quantities and related material-control records shall be taken into account.

d. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. Any generally recognized method of pricing materials issued from stock may be employed, provided the results obtained are equitable. When materials in stock at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, the contractor and the Government may agree upon the use of a

method of pricing based upon the fair value of the materials (but not in excess of replacement cost). Such agreement should include identification of the types or kinds of materials involved and should preferably be made at the time the contract is entered into and provided for therein.

c. Ordinarily inter-company or inter-divisional sales or transfers of materials shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissible when the transactions involve items regularly manufactured and sold by an affiliate or division through commercial channels except as to items on which the Government is ultimately the sole user. In these latter cases, however, the price charged to the contract must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items. In other situations where consideration of the minority interest in an affiliate would warrant departure from the cost basis, such departure may be permitted but only if expressly authorized or approved by the contracting officer.

15-204.23 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See also paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders,

preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings.

The above and similar listed costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.26 PATENT EXPENSES. Included in this item are amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. The cost of preparing disclosures as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application for the Government is allowable. All other patent expenses



and charges for the use of patents where the Government has a license or the right to free use thereof are unallowable. The cost of research and development work leading to patents is treated in subparagraph 15-204.35.

#### 15-204.27 PENSION AND RETIREMENT PLANS

a. As used herein, a pension or retirement plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance or survivorship benefits incidental and directly related to the retirement benefits. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation the employees. The determination of the amount of retirement benefits and received by/the contributions to providesuch benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure acceptance by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that

Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan or the amount actually contributed during the taxable year, whichever is the lesser. The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested

at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, it will be expected that an arrangement will be made which will result, as nearly as may be practicable, in the Government's receiving the benefit of these credits to the same extent as it originally participated in the related costs. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount of current pension costs negotiated and agreed upon in advance. Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans are not allowable.

15-204.28 PLANT PROTECTION EXPENSES. This item includes the cost of plant

protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), and depreciation on plant protection capital assets. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.

15-204.29 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the contractor's business; (iii) the nature and scope of managerial services expected of the contractor's own organization; and (iv) whether or not the proportion of Government production to the

contractor's total production is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to production under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation, defense of anti-trust suits, and the prosecution of claims against the Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.32 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion expenses are not allowable except that the cost of removing Government property and the restoration costs caused by such removal are allowable if specifically provided for in the contract.

15-204.33 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating

an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.34 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.)

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Rentals specified in sale and lease-back agreements under (i) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.35 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract

costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed toward increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all works of the contractor other than its independent research.

(iii) The contractor has submitted a report covering such independent general research projects showing the following:

(1) Description and objectives of the project.

(2) Anticipated total cost.

(3) Cost during the period under review.

(4) Benefits expected to accrue to the mission of the Department of Defense as a result of project.

(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) commercial. (If less than 75% commercial at the time of entering the contract allowance may be authorized by special contract provision.)

The above conditions will also apply in the negotiation of pre-determined overhead rates.

(2) Related research is that type of research which is directed toward practical application of science, and "development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design and production engineering. The costs of a contractor's independent related research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost to any cost type production contract if the research is related to the product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

15-204.37 SERVICE AND WARRANTY EXPENSES. This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to



be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASPR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor is allowable. The amount allowable shall be determined by assigning the total cost of actual mass severance payments to the entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property".

15-204.40 STRIKES AND LOCKOUTS, EXPENSES OF. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits.

15-204.41 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.19); (iii) taxes from which exemptions are

available; and (iv) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

#### 15-204.42 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable.

b. Subscriptions. This item includes the cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

c. Meetings and Conferences. All other entertainment expenses, including those classified as gratuities in accordance with ASPR 7-204.13, are unallowable.

15-204.43 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.44 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such material. (See paragraph 15-204.24). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this

respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.45 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

e. Entertainment expenses are not allowable.

f. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

First Draft  
15 May 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards for the determination of costs to be utilized in connection with the negotiation of prices and cost reimbursements for all contracts under the jurisdiction of the Department of Defense.

15-001 Effective Date of Section. This section shall be complied with on and after \_\_\_\_\_, 1953, although compliance is authorized from the date of its issuance.

PART 1 - APPLICABILITY AND PURPOSE

15-101 General. The principles and standards set forth herein are intended to apply uniformly (except as expressly qualified) to the determination of either estimated or actual costs of performance of all prime contracts and subcontracts, the prices of which are subject to approval or review by the Department of Defense.

15-102 Reasons for Issuance of This Statement. Defense procurement is a matter of great public interest. It is important that it be conducted on a plane that assures the Congress and the taxpaying public that defense materiel is being obtained at fair and reasonable prices without waste and extravagance. It is also important to assure defense manufacturers (especially competitors), of fair and equitable treatment, without discrimination, in contract pricing. A vast amount of defense materiel is obtained, especially in periods of emergency, under conditions where prices cannot be established simply by competitive bidding. The nature of the inherent risks in defense production, especially in the time-length of contract performance, and the frequent absence of complete product specifications, result in the use of various forms of contracts in which prices are determined to a greater-or-lesser degree by the use of cost data -- both estimated and actual. The gathering, analysis, and use of cost data are complex problems, both for contractors and Government negotiators, as well as industrial and Government accountants and auditors who are more skilled in such matters. Cost problems are serious and diverse, both with respect to more basic business practices and to application of appropriate accounting principles. An adequate statement of cost principles and standards is necessary in order to avoid misunderstanding,

as well as confusion, delay, and expense in contract negotiation and administration, including auditing and settlement of contracts. Every defense contractor, therefore, should recognize the necessity of the adoption of these principles and standards in the common good -- not merely for cost-reimbursement-type contracts, but also for other special types of contracts the use of which has greatly increased.

15-103 Application of Cost Estimates. Cost estimates submitted by contractors are used for the following purposes:

- (a) Under outright fixed-price contracts:
  - (1) Negotiating fixed prices, to the extent there is an absence of other objective criteria to enable the determination of a fair and reasonable price.
- (b) Under fixed-price contracts containing price-redetermination provisions:
  - (1) Determination of tentative initial prices.
  - (2) Firm revision of initial prices on a forward basis.
- (c) Under incentive-type contracts:
  - (1) Determination of tentative target prices and target costs when firm targets cannot be initially determined.
  - (2) Determination of firm target prices and target costs, including those cases where there is delayed determination.
- (d) Under cost-reimbursement-type contracts:
  - (1) Initial estimates as a basis for establishing fixed fees.
- (e) Under all the above types of contracts for determination of:
  - (1) Contract price ceilings.
  - (2) Adjustment of prices, price ceilings, targets, fees, etc. for all contract changes.

15-104 Application of Historical (Actual) Costs. Historical (actual) costs are used for the following purposes:

- (a) Under cost-reimbursement-type contracts: retroactive determination of prices.
- (b) Under fixed-price contracts, with retroactive price-redetermination provisions: retroactive determination of fixed-prices based on actual costs, to extent permitted by Armed Services Procurement Regulations.

- (c) Under incentive-type contracts: determination of adjusted prices after contract completion in light of actual costs and adjusted profits or fees, based upon sharing of increased or reduced costs as compared with estimated target costs.
- (d) Settlements in connection with termination of contracts for the convenience of the Government to the extent provided by the Armed Services Procurement Regulations.

15-105 Contract Provisions. Where the nature of a contract requires or may involve future determinations of price, these principles and standards must be incorporated specifically by reference in the contract or be set forth in the contract or appended thereto, in order to be binding upon the Government and upon the contractor. These principles and standards shall be thus made a part of every contract and subcontract whose costs are subject to approval or review by the Department of Defense, or any of its subdivisions, executed as of a date on or after , 1953. Any such contract or subcontract may treat any element of cost thereunder more specifically than provided by this statement of principles and standards so long as there is no inconsistency therein.

15-106 Implementation by the Military Departments. This statement of contract cost principles and standards shall be followed in procurement operations of the three military departments without modification or expansion in any way except as to instructions on administrative procedures or as provided in the last sentence of the preceding paragraph. Any expansion of or change in this section, deemed to be desirable, will be referred to the Office of the Secretary of Defense for consideration. Any interpretations of these principles and standards made in the course of contract administration shall be on a case-by-case basis in the light of the specific facts thereof -- no system of written interpretations to be generally followed will be permitted. Administration of these problems is a matter for practical business judgment rather than rigid adherence to established precedents.



possible assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured regularly and recorded in the formal accounts.

15-203.3 Use of Standard Costs in Determining Actual Costs. Wherever contract price negotiations or settlements depend upon actual costs, and contractors have reasonably satisfactory standard cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent actual costs, provided such costs are believed to otherwise reflect the application of the principles and standards set forth in this section. However, normally where adequate standard costs are available for complete end-products, fixed-price contracts should be used.

15-203.4 Use of Job-Order or Process Cost-Accounting Method. The use of either the job-order or process cost-accounting method in determining historical costs of actual contract performance is acceptable. Wherever there is to be a retroactive determination of initial fixed-prices under a price-redetermination clause, or of a revised target cost under an incentive-type contract, it is essential to determine the actual cost of production of those items delivered upon which the revised price and cost determinations depend; this generally requires separate job costing of that portion of production, but any other method of cost determination may be used which will yield equally reliable results.

15-203.5 Use of Historical Costs for Purposes of Cost Estimating. When used in the preparation of cost estimates, unmodified historical cost data may not provide a satisfactory standard of future performance; in this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-204 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in large volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing of such products. However, in those instances where cost analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not to impose impractical requirements on contractors for cost estimates -- to meet which requirements might result in work entirely disproportionate to the amounts involved. Cost analyses in such cases may sometimes be based upon other data than current cost estimates --

for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales, costs and profit data on a group of products, including the specific one subject to price negotiation.

15-205 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, definite understanding should be reached between the contracting parties. This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be a requirement for specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles.

15-206 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable and reasonably accurate results under the particular circumstances.

15-207 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may be considered in determining either costs or profit (or fee). Major factors to be considered in this respect relate to risks of cost increases or losses in performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government assumes all the risk of cost increases or additional unknown costs, or a major share thereof (as it generally does when these risks are great) through the use of cost-reimbursement-type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for cost contingencies should be reduced to the extent appropriate. Normally in negotiation of prices under outright fixed-price contracts, risks of loss or cost increases will be compensated in allowable profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes. Cost estimates generally include reasonable depreciation on plant and equipment; this cost factor is based largely upon risks of obsolescence of the facilities. In such cases these factors

should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, because interest on borrowed capital is not allowed as a cost, it should be covered in the interest return on capital allowed as a part of profit or fee; again in contracting for construction under cost-reimbursement-type contracts, it is customary practice to exclude general, administrative and financial expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-208 Relation of Contract Cost Principles to Federal Income Taxation. In general, all business costs allowable as deductions for the purpose of determining taxable income under the Internal Revenue Code should be allocated (assigned) to the extent appropriate, to the cost of performance of specific contracts, except as otherwise set forth in this statement of principles and standards.

15-209 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply and research contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, construction contracts and research and development contracts with non-profit institutions, Parts 4, 5, and 6 respectively, are devoted thereto.

15-210 Direct vs. Indirect Costs. Every method of cost accounting or estimating embodies the principle of direct costing of materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance -- for this reason, such allocated expenses are termed "indirect costs."

15-211 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to all classes of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor should follow a consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-215 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

- (a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;
- (b) Engineering expenses to extent not included in (a) or (c);
- (c) Selling and distribution expenses, incurred in marketing the products manufactured;
- (d) General and administrative expenses incurred in the overall management, supervision, and conduct of the business;
- (e) Financial and other expenses.

15-216 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The best general test which may be applied to determine an appropriate method is to find the answer to the question: Does the method result in an allocation of the indirect costs to the products, job orders, or contracts, most equitably in relation to the machine or other work being performed on each?

15-216.1 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. This involves determination by the contractor of expense rates in accordance with whatever method or methods of expense allocation are followed. In accordance with the aim of encouraging the use of standard costs (paragraph 15-203.2), contractors should be encouraged to use accepted standard cost methods of budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses by cost centers in proportion to estimated levels of production or work loads; such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

(b) The use of predetermined rates for indirect expenses is acceptable in lieu of actual rates of indirect expenses in determining otherwise historical costs of products or contracts, including costs under cost-reimbursement-type contracts, provided there is reasonable assurance that

the results would be fairly comparable with the use of actual rates. This practice may expedite the determination of contract prices and reduce auditing. When predetermined expense rates are so used, the contractor must exclude from direct costs any cost element included in predetermining expense rates in order to avoid duplicate charges.

15-219 Financial and Other Expenses and Federal Income and Excess Profits Taxes. Neither product nor contract costs shall include interest charges (except under special circumstances -- see Part 3) or Federal income taxes because such charges are allowed for in determining overall prices. It would be improper to allow for Federal excess profits taxes in determining overall prices. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Any other financial or miscellaneous expenses must be considered item by item in determining costs of a product or contract.

PART 3--APPLICATION OF COST PRINCIPLES IN SUPPLY AND  
RESEARCH CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part sets forth, in some detail, applications of cost principles and standards of Part 2 of this Section in determining costs to be utilized in connection with the negotiation of prices and cost reimbursements for all contracts other than (i) facilities contracts, (ii) construction contracts and contracts for architect-engineer services related to construction, and (iii) research and development contracts with educational or other nonprofit institutions. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when the items contained in this part do not furnish specific guidance, cost determinations should be made in light of the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3.

15-310 Manufacturing Costs.

15-311 Materials. The costs of materials, both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. As used hereinafter, the term "materials" includes subcontract work.

15-311.1 Collateral Elements of Material Cost. In establishing direct material costs, consideration may be given to including the following elements, to the extent they are reasonable:

- (a) transportation, insurance, purchasing, receiving, handling, and storage;
- (b) overruns, spoilage, and defective work;
- (c) adjustments between book and physical inventories due to variations in weights and measures and errors in record-keeping reasonably related to the period of contract performance.

To the extent such items are included as direct material cost, no additional allowance therefor may be made in the determination of manufacturing expenses. If not so handled, they are properly includable in manufacturing expenses.

15-311.2 Material Credits. In establishing material cost, effect shall be given, either directly or as a reduction of total manufacturing costs, to such items as:

- (a) Cash discounts taken. However, in determining costs under cost reimbursement-type contracts, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be excluded in determining allowable costs;

- (b) Trade discounts, rebates, and allowances on material purchased;
- (c) Value of scrap and salvage and materials returned to vendors.

**15-311.3 Pricing.**

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. However, if the contractor so elects, materials in inventory or under binding purchase contracts at the commencement date of a Government contract may be charged to the Government contract at provable replacement cost as of the date of its commencement, provided that, once the election is made, the method must be followed consistently thereafter. When special materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. Costs of subcontract work should be determined similarly; provided that, when subcontracts are performed under contract pricing arrangements other than outright fixed prices, the determination of prices shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market prices or replacement cost may be used, provided, under most circumstances, replacement cost is not in excess of current market. In order to avoid the allowance of contingencies in cases in which replacement cost may be estimated to be in excess of market, escalation or price-redetermination provisions may be made a part of the contract. However, situations involving increases in material costs which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

(c) In cases in which the contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, and it is possible objectively to determine market prices thereof, such prices may be used in determining or estimating the cost of the composite product. In objectively determining market prices, consideration may be given to the lowest sales price to nonaffiliated customers, if any, of the transferror for like items, quantity and quality considered. When objective pricing in such situations is not possible, the cost of materials so transferred or acquired shall be no greater, for pricing purposes, than the cost to the transferror. An exception to this may be made in case of suppliers in which nonaffiliated parties hold a minority interest of 10% or more. Under such conditions a reasonable margin of profit on such sales, in recognition of the minority interest, may be permitted by agreement. In other cases when there are indications that less than an arm's length relationship exists between the contractor and the supplier, similar consideration is required in determining the propriety of the amounts allowed as contract costs. Whenever such purchases of materials are made at other than cost to the supplier, pursuant to the provisions of this paragraph, they shall be treated as subcontracts in determining the profit or fee.

15-312 Labor. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

Common labor services may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. Similarly, supplemental or premium pay and fringe benefits may be so treated, although the relative size of such payments in relation to base pay may indicate the desirability of treating them as a separately identifiable direct labor charge as indicated herein-after in this Part.

15.312.1 Fringe Benefits--Vacations, Holidays, Sick Leave, Military Leave, Severance Pay, Pension and Retirement Plans, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

"Fringe benefits" arise because of the work performed by the employee while on the job, and the cost thereof must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatment accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves,



recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable. Also, severance payments made in the event of termination should not be allocated entirely to the terminated portion of the contract or even to the terminated contract, since the employee's right to severance pay has accrued over his entire period of employment.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship to defense business as compared with nondefense business (for example, severance pay and pension costs--which may have an opposite relationship).

(d) Regardless of the accounting treatment accorded these costs in the contractor's accounts, an equitable amount may be determined by establishing an experience rate for such costs based on a representative period. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to semianual revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix \_\_ to this Section.

Employee insurance includes group insurance and individual life and accident insurance.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify the amounts of other than occasional overtime. Whenever such allowances are claimed as costs, prior approval of the contracting officer must be obtained.

Such premiums may be classified as either direct or indirect labor cost, but should be separately stated in either event. Where treated as direct labor cost, they should not be included in the base for distribution

of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

### 15-313 Other Manufacturing Expenses.

15-313.01 Method of Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foremen, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, etc.) to the productive departments on appropriate bases before allocating the respective productive department expenses to products (or parts thereof) or to contracts or job orders for products. Appropriate bases should be selected for service-department and other expense distributions to productive departments--e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor-effort, in any productive department it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is more appropriate for expense allocation. The units-processed-basis of allocation is appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator--e.g. steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Whenever engineering activities are substantial, it is appropriate that the expenses be separately allocated so far as feasible to products, job-orders, contracts, etc. The work to which expenses are allocated may include facilities or

equipment constructed or acquired and research and development work, as well as products. Engineering activities include product design, tool design, layout of production lines, determination of machine methods, drafting, etc. Engineering labor should generally be direct costed, as should any other major items of engineering expenses. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in Part 3 of this Section; facilities contracts are covered under Part 4.

15-313.03 Depreciation and Amortization. Depreciation on a contractor's plant and equipment and other capital facilities is an allowable element of contract cost, usually but not always of an indirect nature. It is the most difficult element of cost to determine because determination is largely a matter of judgment or opinion.

(a) In determining annual depreciation on the cost of a contractor's facilities, the following shall be considered:

(i) In the case of buildings and most machinery used in manufacturing, prospective economic obsolescence, either individually by item or enmasse, and not wear and tear, is the major factor covered by the depreciation charge. Wear and tear of such facilities may be made good indefinitely by repairs and maintenance. On the other hand, in the case of automobiles and certain items of machinery and equipment, as time goes on the excessive cost of repairs and maintenance makes it more economical to replace the items after a certain optimum period of use or age. Again, some items are expendable in use. Obsolescence of facilities may be brought about by reduced economic utility without loss of productive utility, such as by technological changes affecting the economic use of individual machines. Special requirements for relocation of facilities may also result in obsolescence. Obsolescence is always prospective with reference to an entire enterprise or an individual plant as well as individual items of plant and equipment. Defense industries generally have a special problem of obsolescence due to their character.

(ii) In general, every contractor is entitled to write off the entire cost (less estimated salvage value, if any) of facilities used in production over their estimated useful life in anticipation of possible obsolescence or replacement for other reasons, without requirement for proof of economic obsolescence accrued at any time from a technical standpoint. This will generally mean that the cost of facilities will be written off before their productive usefulness actually expires. Depreciation is too intangible to warrant attempts at meticulous determination by individual items of plant and equipment, although such attempts are frequent and may be recognized. Hence, depreciation will generally be determined by types of facilities, in each of which the items are subject to similar incidence of obsolescence or other causes of replacement. The amount of depreciation written off in any fiscal period may vary with volume of production, provided a systematic method is followed consistently from year to year which is directed at

the primary objective of writing off the cost of facilities over their useful life. Generally, when such a method is employed in the case of any facilities subject primarily to loss through obsolescence, the adjusted rates should be less than normal when production volume is below normal to compensate for higher rates where production is greater than normal (the term "normal" being used in the sense of "average").

(iii) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year. No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the provisions of the Internal Revenue Code governing the tax basis of facilities values are applicable.

(iv) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect a recovery thereof as a charge against defense contracts or subcontracts in initial negotiated pricing or renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(v) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for standby purposes including additional plant capacity reserved for defense production.

(b) In applying the foregoing considerations, depreciation rates established with the approval of the Bureau of Internal Revenue for income-tax purposes generally may be utilized in determining contract costs. When such rates have not been approved, it may be necessary to use independent judgment in the determination of reasonable rates. Bulletin F of the Bureau of Internal Revenue provides general guidance for income-tax purposes on depreciation rates for normal facilities in normal peacetime use; care must be taken in the use of Bulletin F rates for purposes of contract

pricing as they may not be typical for the facilities of any specific contractor or industry, especially when the facilities are acquired for emergency use. Special methods have been established for determining depreciation on emergency facilities subject to Certificates of Necessity authorizing special tax amortization by a special directive set forth in an appendix of this Section. When a contractor desires to establish depreciation rates which vary in relation to production there must generally be a departure from the depreciation method used for income-tax purposes. Again, the allowance of a computation of annual depreciation upon costs adjusted to current-price levels is at variance with income-tax depreciation methods.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's depreciation policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government for use during periods in which the contractor will have little defense business. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.07 "Preparatory Costs"). In some instances, allowance of substantial extraordinary rehabilitation expenses as a charge against defense business may be conditioned upon the contractor's agreement to hold the facilities available for defense work for a stated minimum period. Repairs and maintenance costs on facilities which are not in use will not be allowed, except on facilities held for standby purposes including additional plant capacity reserved for defense production.

15-313.05 Profits or Losses on Disposition of Plant and Equipment. Normally, in determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for the reason that depreciation, reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and termination of contracts finds such facilities not fully depreciated, an additional cost allowance may be made in determining costs

of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any salvage value estimated for such facilities.

15-313.06 Rentals of Plant and Equipment. Ordinary rentals of plant or equipment are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs will not be considered to be bona fide under the following circumstances:

(a) Rentals are paid to persons, including corporations, affiliated with the contractor.

(b) Rentals are paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer through charges against the costs of defense business.

In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.07 Preparatory Costs, including Engineering. Preparatory costs or expenses, also known as "make-ready costs," are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and planning of production processes and layout) and plant alteration and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.08 of this Part.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision covering the allowability of pre-award preparatory costs should be incorporated in any definitive contract when future pricing or repricing may be based in part upon actual contract costs. However, the absence of such provision will not preclude consideration of the costs in subsequent price negotiations or determinations under such contracts.

**15-313.08 Initial Production Costs.** Initial production costs, also known as "starting-load costs," are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs"), which comprise such costs as tooling, engineering and development, and cost of equipment, and which are treated separately in this Section.

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventually attainable during the operation of the entire contract. If, however, rejects continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the resulting excessive costs may not properly be allowable for purposes of cost estimating for formal pricing purposes or in establishing costs under terminated contract settlements.

**15-313.09 Reconversion Expenses.** Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to beginning of defense work, including the removal of Government-furnished property. Such expenses exclude the costs of acquiring and installing entirely new or different equipment or otherwise altering the facilities for an entirely different purpose after defense work is completed. Specific contractual provisions may be included in cost-reimbursement-type contracts to compensate the contractor for actual reconversion costs incurred. Reconversion expenses may also be allowed as an element of contract costs in other types of contracts on the basis of reasonable estimates under the following conditions:

(a) The contract price contains no other allowance for use of facilities which would compensate the contractor for reconversion expenses.

(b) The facilities must have been altered or rearranged at the inception of defense work or they were newly acquired buildings in which Government machinery and equipment has been installed.



(c) There must be a reasonable basis for the assumption that the facilities must and will be reconverted.

(d) Reconversion costs shall be allowed only in pricing those contracts in existence or being actively negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional contracts, care must be exercised to avoid duplications of allowances for reconversion costs.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contracts. The cost of tooling which is special to other classes of work will be allocated to such work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is presented elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation, when the resultant charges are reasonably equitable between fiscal years. When the entire cost has been allocated to Government contracts, the asset concerned shall become contractor-acquired Government property and be subject to the provisions of Section XIII and Appendices B and C, ASPR, applicable to contractor-acquired Government property.

15-313.11 Research and Development. Research and development expenses may be divided into two major categories--product research and general research.

(a) Product research is that research which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The costs of current product research are allowable as costs on defense contracts and may be allocated thereto to the extent applicable to the supplies or services covered by the contracts, provided such costs are not reimbursed to the contractor under separate research contracts.

(b) General research is all research other than that which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under



separate research contracts. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods.

(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are allowed as provided in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of less than arm's length bargaining. Royalty costs will not be considered to be bona fide under the following circumstances:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents. (See Section IX, ASPR)

15-313.13 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs

of individual equipment, cost of plant equipment if of minor amount, and depreciation of plant equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements without additional charge to the Government. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection will be allowed the contractor. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government.

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

#### 15-313.14 Insurance and Bonds.

(a) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allocable. Some, but not all, of the types of

coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, and employees' fidelity and surety bonds (including performance bonds).

(b) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-312.1).

(c) When a contractor assumes insurable risks of any type, a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies.

#### 15-313.15 Taxes.

(a) In general, all taxes paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes (see paragraph 15-219). Special assessments on land are not allowable because they represent capital improvements.

(b) The Federal Government is subject to certain exemptions from payment of Federal customs duties and excise taxes and State sales or use taxes on the purchase of materiel, either directly or for conversion, as indicated in Parts 2 and 3 of Section XI of the Armed Services Procurement Regulations. On the other hand, such taxes are generally properly assessed on materials and property purchased by a defense contractor. It is generally illegal for a State or local authority to assess a contractor for property taxes upon the basis of including in his assessed property valuation any amount for Government-furnished property. For this purpose, the Government is not considered to own raw materials in stock or work in process acquired and fabricated by the contractor under contracts subject to progress payments or advance financing, including cost-reimbursement-type contracts.

(c) Whenever taxes are believed to be illegally assessed against the contractor and the cost thereof may be included in historical costs for the purpose of contract pricing, contractors should request contracting officials for instructions concerning the payment of such taxes, possibly under protest, and with further respect to instituting litigation to obtain tax refunds, including interest, in which the Government would share in ratio to the charge made against the contracts. When litigation is involved in which the Government has an interest, it will bear its share of expenses of litigation either as a contract cost or as a reduction of any recoveries of costs for its account.

(d) State income taxes are an allowable item of cost, subject to a reasonable allocation to defense business, considering if desirable the

portion of total taxable profits which may be attributable to such business. Allowance of such taxes is necessary from the standpoint of equity, because many State or local governments do not have an income tax, and those which do, use it in lieu of some other form of taxes which would be an allowable element of contract costs.

**15-313.16 Strikes and Lockouts.** The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

**15-320 Selling and Distribution Expenses.**

**15-320.1 Basis of Allocation of Selling and Distribution Expenses.** Selling and distribution expenses in general are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and nondefense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charged to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to nondefense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities sold are so abnormal in relation to sales effort that such an averaging of costs would result in significantly excessive total cost estimates. In the latter case, the fixed selling expenses should be charged to normal nondefense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 re advertising.

Many businesses have not yet extended refined methods of cost accounting to selling and distribution expenses; in this, there is a lag behind methods of cost accounting for manufacturing expenses--in consequence improvements in cost accounting in this area are more frequently required than in the area of manufacturing costs.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

#### 15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, provide uniformity of treatment for like cost elements, be applied consistently, and produce equitable results. A previously acceptable method shall be subject to reconsideration when:

- (i) any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or
- (ii) any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the inventories, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other relevant circumstances.

Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but normally no longer than a year. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable

to the manufacturing and productive process as a whole. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift work) units processed, and prime costs of units processed. Departmentalization or the establishment of cost centers may be necessary in order to allocate the indirect costs equitably. Factors to be considered in determining the necessity for departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include such items as costs of engineering supervision, engineering administration, and engineering supplies. Direct engineering activities from which indirect engineering costs may arise may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift work), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include the costs of sales promotion, advertising, distribution, and other related activities. Generally, such costs are not allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

- (i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);
- (ii) processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct materials);
- (iii) factory input costs (processing costs plus direct material);

cost of ... is completed;

cost of sales; and

sales (where no more satisfactory method is available).

### Principles and Standards for Selected Items of Cost.

General. Applications of the above basic cost principles and standards to the selected items of cost are set forth below. These applications cover the particular item of cost is treated by the contractor as direct or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to items, whether or not specifically covered, determination of allowability is based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

### Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the cost of advertising media and corollary administrative costs. Advertising media include newspapers, radio and television programs, direct mail, trade publications, outdoor advertising, dealer cards and window displays, conventions, free goods and samples, and sales literature. The following advertising costs are allowable:

- (i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and

- (ii) help wanted advertising, as set forth in (t) below.

Other advertising costs are unallowable.

(b) Bidding Costs. Bidding costs are the costs of preparing bids and proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained shall be accepted only if found to be reasonable and equitable.

(c) Civil Defense Costs. Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training supplies, fire fighting training and equipment, posting of additional

defense measures) under-  
defense authorities  
r. Costs of capital  
incurred in accordance  
with, or to projects  
(below).

Compensation is  
reimbursement. The term  
includes pension, re-  
tirement, royalties,  
set forth here-  
under and the  
consideration  
for the services  
rendered, is allowable

Established by the  
contractor. How-  
ever, directors,  
officers and  
employees appear  
to be compensation are  
allowable or is  
contractor's  
costs or a small  
amount related to  
amount of com-

Contractor  
cost.

Costs to em-  
ployees, rep-  
resentatives

standing  
before the  
established  
contractor.

Light

Incurred by

- (iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.
- (v) Allowable as an ordinary or necessary business expense for tax purposes.
- (vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

- (i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation) which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.
- (ii) The cost of profit-sharing plans shall be treated as follows:
  - (A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.
  - (B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

- (i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.
- (ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.
- (iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.



- (iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost.

(f) Depreciation. (1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed:

- (i) upon the property cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); or
- (ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income tax; and in either case
- (iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

- (i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and
- (ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (4) below); provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(4) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities or facilities controlled by the contractor. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable when it is the policy of the contractor to operate such services at a profit or at cost; provided, however, that such losses are allocated to all activities served. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of providing a reserve for a self-insurance program are unallowable unless the program has been approved by the Military Department concerned; and
- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(k) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(1) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(2) Costs of maintenance and repair, which are delayed from a period prior to the contract for some reason such as abnormal operating conditions or lack of funds and are performed during the contract period, are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract are unallowable unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

(i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

(ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production;

are allowable.

(n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work).

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of performance if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of:

(i) the cost to the transferor; or

(ii) the prices of other suppliers for the same or substantially similar items;

whichever is the lower, unless factors other than price warrant allowance on the basis of the cost to the transferor; provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed:

(i) the transferor's sales price to its most favored customer for the same item in like quantity; or

(ii) the prices of other suppliers for the same or substantially similar items;

whichever is the lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs, in connection with the filing of a patent application where title is conveyed to the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q).).

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of:

(i) contractors who are subject to Federal income tax, and

(ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) the requirements of ASPR 15-201.2 shall be satisfied;
- (ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), shall not exceed —
  - (A) the amount claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, the amount which could have been claimed and deducted for Federal income tax purposes in the current taxable period had such organizations been subject to the payment of income tax;
- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which —
  - (A) are disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax-exempt organizations, could have been disallowed for tax purposes had such organizations been subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
  - (A) when such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or in some other writing binding on the Government and the contractor; or



(B) when such abnormal termination credits or gains, whether or not foreseeable --

(I) cannot be currently evaluated with reasonable accuracy; or

(II) have not been the subject of adjustment under (A) above;

pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for such subsequent termination credits or gains unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(r) Plant Protection Costs. Costs of items such as wages, uniforms and equipment of personnel engaged in plant protection; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(s) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

- (i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;
- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organizations; and

- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(u) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (m) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract; provided the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line; and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204.3(k)).

(w) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs incurred thereafter are unallowable.

(x) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement; (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

- (i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severance such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and
- (ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the employment of the terminated employees and equitably allocated to all work performed in the contractor's plant during that period. A reservation in the final release may be made when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and

- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable cost of any such action undertaken by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to assure timely direction after prompt request therefor, are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government, provided any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties.

(aa) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

(1) Costs of preparation and maintenance of a program of instruction at noncollege level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

- (i) salaries of the director of training and staff when the training program is conducted by the contractor; or

- (ii) tuition and fees when the training is in an institution not operated by the contractor;

are allowable.

(2) Costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, including only:

- (i) training materials;
- (ii) textbooks;
- (iii) fees charged by the educational institution;
- (iv) tuition charged by the educational institution, or in lieu of tuition, instructors' salaries and the related share of indirect cost of the educational institution, to the extent that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution; and
- (v) straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours;

are allowable.

(3) Costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with full-time scientific and engineering education at a post-graduate (but not under-graduate) college level related to the job requirements of bona fide employees for a total period not to exceed one school year for each employee so trained, are allowable. In unusual cases where required by military technology, the period may be extended.

(4) Maintenance expense, and normal depreciation or fair rental, on facilities owned or leased by the contractor for training purposes are allowable to the extent set forth in (l), (f) and (u) above, respectively.

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see (e) above).

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(4) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

(c) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see ASPR 15-204.2(g), (i), and (aa)).



(d) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(e) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

(g) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) Advertising Costs, ASPR 15-204.2(a), last sentence;
- (ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)
- (iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;
- (iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;
- (v) Recruiting Costs, ASPR 15-204.2(t), last sentence;
- (vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and
- (vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) Depreciation, ASPR 15-204.2(f)(5), first sentence;
- (ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;
- (iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
- (iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);
- (v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

- (vi) Patent Costs, ASPR 15-204.2(p), second sentence;
- (vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;
- (viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);
- (ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);
- (x) Taxes, ASPR 15-204.2(z)(2); and
- (xi) Travel Costs, ASPR 15-204.2(dd)(4).

29 March 1956

*Case  
53-44*

Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations from the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations set forth in this Part 2 or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

#### 15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift, work) units processed, and prime costs of units processed. Departmentalization or the establishment of cost centers may be necessary in order to allocate the indirect costs equitably. Factors to be considered in determining the necessity for departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include such items as costs of engineering supervision, engineering administration, and engineering supplies. Direct engineering activities from which indirect engineering costs may arise may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and

related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift, work), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include the costs of sales promotion, advertising, distribution, and other related activities. Generally, such costs are not allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

- (i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;
- (ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

- (iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and
- (iv) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. The following advertising costs are allowable:

- (i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and
- (ii) help wanted advertising, as set forth in (t) below.

All other advertising costs are unallowable.



(b) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(c) Civil Defense Costs. Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. Costs of capital assets acquired for civil defense purposes shall be depreciated in accordance with (f) below. Except as specifically provided for in the contract, contributions to local civil defense funds, or to projects not on the contractor's premises, are unallowable.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness of the amount of particular contributions and donations, and the aggregate thereof for each fiscal period, must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof:

- (i) is computed upon the cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); and
- (ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

- (i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and
- (ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (4) below; provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(4) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable when it is the policy of the contractor to operate such services at a profit or at cost; provided, however, that such losses are allocated to all activities served. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of providing a reserve for a self-insurance program are unallowable unless the program has been approved by the Military Department concerned; and
- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(k) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(2) Costs of maintenance and repair which are delayed from a period prior to the contract, for some reason such as abnormal operating conditions or lack of funds, and are performed during the contract period are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract are unallowable unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

- (i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

- (ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production;

are allowable.

(n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work.

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of performance if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;

provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed either (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs, in connection with the filing of a patent application by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by

the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of :

- (i) contractors who are subject to Federal income tax; and
- (ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) the requirements of ASPR 15-201.2 shall be satisfied;



- (ii) such costs, including excess contributions (see Section 404(a)(i)(D) of the Internal Revenue Code of 1954), shall not exceed —
  - (A) the amount claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, the amount which could have been claimed and deducted for Federal income tax purposes in the current taxable period had such organizations been subject to the payment of income tax;
- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which —
  - (A) are disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax-exempt organizations, could have been disallowed for tax purposes had such organizations been subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
  - (A) when all such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current

costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or in some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable —

(I) cannot be currently evaluated with reasonable accuracy; or

(II) have not been the subject of adjustment under (A) above;

pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for such subsequent termination credits unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(r) Plant Protection Costs. Costs of items such as wages, uniforms, and equipment of personnel engaged in plant protection; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(s) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

- (i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;
- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organization; and
- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for the contract.

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(u) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

- (i) scope, nature, and quality of the contractor's independent general research program;
- (ii) capability of the contractor in the particular research field;
- (iii) benefits which may accrue to the Government;
- (iv) comparison of size and cost of contractor's previous years' independent research programs; and
- (v) proportion of Government business to contractor's total business.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (m) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract; provided the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line; and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs incurred thereafter are unallowable.

(x) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

- (i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and
- (ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the employment of the terminated employees and equitably allocated to all work performed in the contractor's plant during that period. A reservation in the final release

may be made when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

(aa) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.



(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(4) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

- (i) ASPR 15-204.3(e);
- (ii) ASPR 15-204.3(i); and
- (iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

(c) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see ASPR 15-204.2(g), (i), and (aa)).

(d) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(e) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)).

(g) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(h) Organization Costs. Expenditures, such as incorporation fees, attorneys fees, accountants fees, brokers fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-lxx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) Advertising Costs, ASPR 15-204.2(a), last sentence;
- (ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;
- (iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;
- (iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;
- (v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and
- (vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;
- (ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;
- (iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;
- (iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
- (v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);
- (vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;
- (vii) Patent Costs, ASPR 15-204.2(p), second sentence;

- (viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;
- (ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);
- (x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);
- (xi) Special Tooling Costs, ASPR 15-204.2(z)(2);
- (xii) Training Costs, ASPR 15-204.2(bb), last sentence; and
- (xiii) Travel Costs, ASPR 15-204.2(dd)(4).

29 March 1956

*Case  
53-44*

Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations from the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations set forth in this Part 2 or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

#### 15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift, work) units processed, and prime costs of units processed. Departmentalization or the establishment of cost centers may be necessary in order to allocate the indirect costs equitably. Factors to be considered in determining the necessity for departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.

15-203.3 Indirect Engineering Costs. Indirect engineering costs include such items as costs of engineering supervision, engineering administration, and engineering supplies. Direct engineering activities from which indirect engineering costs may arise may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and



related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of premiums for overtime, extra-pay shift, and multi-shift, work), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include the costs of sales promotion, advertising, distribution, and other related activities. Generally, such costs are not allowable as a charge to Government cost-reimbursement type contracts (but see ASPR 15-204.2(b)). However, subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, rather than pure selling, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

- (i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;
- (ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

- (iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and
- (iv) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. The following advertising costs are allowable:

- (i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and
- (ii) help wanted advertising, as set forth in (t) below.

All other advertising costs are unallowable.

(b) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(c) Civil Defense Costs. Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. Costs of capital assets acquired for civil defense purposes shall be depreciated in accordance with (f) below. Except as specifically provided for in the contract, contributions to local civil defense funds, or to projects not on the contractor's premises, are unallowable.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness of the amount of particular contributions and donations, and the aggregate thereof for each fiscal period, must be judged ordinarily in light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof:

- (i) is computed upon the cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); and
- (ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

- (i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and
- (ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (4) below; provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(4) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable when it is the policy of the contractor to operate such services at a profit or at cost; provided, however, that such losses are allocated to all activities served. When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

- (i) types and extent of coverage shall be in accordance with sound business practice and the rates shall be reasonable under the circumstances;
- (ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;
- (iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are unallowable except to the extent that the Government shall have approved or required such insurance or reserve;
- (iv) costs of providing a reserve for a self-insurance program are unallowable unless the program has been approved by the Military Department concerned; and
- (v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

(k) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities are allowable.

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(2) Costs of maintenance and repair which are delayed from a period prior to the contract, for some reason such as abnormal operating conditions or lack of funds, and are performed during the contract period are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract are unallowable unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

- (i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

- (ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production;

are allowable.

(n) Material Costs.

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work.

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond its control, such lost discounts need not be so credited.

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results obtained are equitable.

(5) Reasonable charges or credits arising from a difference between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of performance if such charges or credits (i) do not include "write-downs" or "write-ups" of value, and (ii) relate to the period of performance of the contract.

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;



provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed either (i) the transferor's sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other suppliers for the same or substantially similar items.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. Upon the written authorization of the contracting officer, costs of preparing documents, and any other patent costs, in connection with the filing of a patent application by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by

the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall not be considered to be pension plans within this paragraph (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d Sess., 68A Stat. 134). Prior to approval of such plans by the cognizant Department, approval by Internal Revenue Service shall be obtained in the case of :

- (i) contractors who are subject to Federal income tax; and
- (ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned. In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) To the extent pension plans are approved by the cognizant Military Department, costs thereof are allowable subject to the following conditions:

- (i) the requirements of ASPR 15-201.2 shall be satisfied;

- (ii) such costs, including excess contributions (see Section 404(a)(i)(D) of the Internal Revenue Code of 1954), shall not exceed —
  - (A) the amount claimed and deductible for Federal income tax purposes in the current taxable period; or
  - (B) in the case of nonprofit or tax-exempt organizations, the amount which could have been claimed and deducted for Federal income tax purposes in the current taxable period had such organizations been subject to the payment of income tax;
- (iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which —
  - (A) are disallowed for tax purposes; or
  - (B) in the case of nonprofit or tax-exempt organizations, could have been disallowed for tax purposes had such organizations been subject to the payment of income tax; and
- (iv) in determining the net pension plan costs allocable to military contracts, and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover, consideration shall be given, in accordance with (A) or (B) below, to possible future abnormal termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans —
  - (A) when all such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current

costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated; and such adjustment shall be reflected in the contract, in an amendment thereto, or in some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable —

(I) cannot be currently evaluated with reasonable accuracy; or

(II) have not been the subject of adjustment under (A) above;

pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for such subsequent termination credits unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment; any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

(r) Plant Protection Costs. Costs of items such as wages, uniforms, and equipment of personnel engaged in plant protection; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

(s) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

- (i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;
- (ii) the impact of Government contracts on the contractor's business;
- (iii) the nature and scope of managerial services expected of the contractor's own organization; and
- (iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for the contract.

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(u) Rental Costs (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories, for the purpose of contract costing: (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research; and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

- (i) scope, nature, and quality of the contractor's independent general research program;
- (ii) capability of the contractor in the particular research field;
- (iii) benefits which may accrue to the Government;
- (iv) comparison of size and cost of contractor's previous years' independent research programs; and
- (v) proportion of Government business to contractor's total business.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (m) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type production contract; provided the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line; and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost-reimbursement type research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, shall not be allocated to that contract unless allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs incurred thereafter are unallowable.

(x) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

- (i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and
- (ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the employment of the terminated employees and equitably allocated to all work performed in the contractor's plant during that period. A reservation in the final release



may be made when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

- (i) Federal income and excess profits taxes;
- (ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));
- (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and
- (iv) special assessments on land which represent capital improvements.

(2) Taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

- (i) promptly requests instructions from the contracting officer concerning such taxes; and
- (ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

(aa) Trade, Business, Technical, and Professional Activity Costs.

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(3) Subsistence and lodging, including tips or similar incidental costs, are allowable either on an actual or per diem basis. The basis selected shall be consistently followed.

(4) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

- (i) ASPR 15-204.3(e);
- (ii) ASPR 15-204.3(i); and
- (iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

(a) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs are unallowable.

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

(c) Entertainment Costs. Costs of amusement, diversion, social activities, and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see ASPR 15-204.2(g), (i), and (aa)).

(d) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(e) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)).

(g) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable as a cost of performance of the Government contract.

(h) Organization Costs. Expenditures, such as incorporation fees, attorneys fees, accountants fees, brokers fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-lxx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion costs are unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

- (i) Advertising Costs, ASPR 15-204.2(a), last sentence;
- (ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;
- (iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;
- (iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;
- (v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and
- (vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

- (i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;
- (ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;
- (iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;
- (iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
- (v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);
- (vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;
- (vii) Patent Costs, ASPR 15-204.2(p), second sentence;

- (viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;
- (ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);
- (x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);
- (xi) Special Tooling Costs, ASPR 15-204.2(z)(2);
- (xii) Training Costs, ASPR 15-204.2(bb), last sentence; and
- (xiii) Travel Costs, ASPR 15-204.2(dd)(4).

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SECTION XV SUBCOMMITTEE

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15-200 SCOPE OF PART. This part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contract and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, and allowances, received by or accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and

\* *Notes and Filing Instructions. This Part may be used for "facilities" pending publication of a Part for this purpose*



are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of all items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product. Costs of reasonable overruns, spoilage, and defective work may also be included (as to defective work, see paragraph 7-203.5(c)).

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. Average rates may be used where it is demonstrated by the contractor that the results are equitable. Direct labor may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are incurred in the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. The contractor may departmentalize or establish cost centers in order to distribute equitably the

indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses include engineering supervision, engineering administrative expense, engineering general supplies, and other related expenses. These expenses arise out of engineering activities which may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods and related blueprinting and drafting.

Indirect engineering expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor <sup>(see also paragraph 15-204.3H.C)</sup> ~~(including independent research projects)~~ on the basis of direct engineering man-hours expended, direct engineering labor dollars <sup>, extra pay shift and multi-shift</sup> (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the

contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and other relevant factors including those mentioned in para. 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should <sup>be representative of</sup> approximate the period of contract performance ~~or should be representative of that period.~~ <sup>and</sup> The base period should be sufficiently long to avoid inequities in the allocation of costs, <sup>but in no event longer than the contractor's fiscal year.</sup>

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST

This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected

items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards herein and, where appropriate, the treatment of similar or related items in this Part.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

- (1) Advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry.
- (2) Help wanted advertising, as set forth in paragraph 15-204.32.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no

bidding expenses of past accounting periods will be allocable in the current period to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation of these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of civil

defense measures undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract, contributions to local/<sup>civil</sup> defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES. (To be inserted later on this page and pages 1509, 1510 and 1511).

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.15).

15-204.8 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established nonprofit charitable, scientific and educational organizations are allowable provided that such costs are reasonable and are properly allocated to all work.

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The propriety of the amount of particular contributions and donations and the aggregate thereof for each fiscal period must be judged ordinarily in light of the pattern of past contributions particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method



followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed for assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facility concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. <sup>(INSERT)</sup> The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility.

The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these

activities will be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.26, 15-204.6 and 15-204.37 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 204.15e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INSURANCE AND INDEMNIFICATION.

~~a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and~~

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15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for war and occupancy insurance will ~~be~~ ~~principles~~ be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) ~~Costs~~ <sup>Costs of a reserve for</sup> costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) ~~Provision for losses under~~ <sup>Cost of a reserve for</sup> a self insurance program are allowable provided the program has been approved by the Military Department concerned.

(iv) ~~Costs~~ costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For

example, see ASFR 7-203.22).

*Except as otherwise <sup>expressly</sup> provided in the contract,*  
~~When the costs of insurance would have been allow-~~  
~~able under paragraph b, above,~~ actual losses, not reimbursed by insurance ~~therefor~~  
~~or failure to insure~~ (through an approved self insurance program or otherwise),  
are not allowable.

(2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limits as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. Provision for losses under a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless approved by the Department concerned.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.16 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection

with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.39. These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.39. \*\*\*

15-204.17 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.18 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a *(including the contractor's contributed portion under cost sharing R+D contracts)* supply, research and development or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.19 MAINTENANCE AND REPAIRS.

a. This item includes those costs necessary for the upkeep of property <sup>otherwise</sup> (including Government property unless/provided for) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.20 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable.

15-204.21 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph 7-203.5(c)). These costs are allowable subject, however, to the provisions of subparagraphs b. through f. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, credits for scrap and salvage and materials returned to vendors. Such discounts, rebates, allowances and credits, may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are equitable. ~~Where materials in stock at the~~

~~commencement date of the contract have a provable replacement cost significantly higher than book cost, the contractor and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.~~

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (1) do not include "write-downs" of values, and (2) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. In the case of any item regularly manufactured and sold by any such transferor through commercial channels a departure from this cost basis is permissible, provided that the price charged to the contract does not exceed the lower of (1) the transferor's sales price to its most favored customer for the same item in like quantity, or (2) the prices of other suppliers for the same or substantially similar items.

15-204.22 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, <sup>accountants fees,</sup> fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.16).

15-204.23 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy



solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. ~~This item consists~~

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount

of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

~~ization of the cost of patented patents applicable to contract products or processes is allowable. The cost of preparing disclosures and other reports as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application by or for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of~~

~~patents where the Government has a license or the right to free use thereof, are unallowable unless otherwise provided in the contract. The cost of research and development work leading to patents is treated in subparagraph 15-204.34.~~

15-204.26 PENSION PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance or survivorship benefits incidental and directly related to the pension benefits. Such benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially. (Retirement plans which are based on profit-sharing shall be subject to paragraph 15-204.6e).

b. Pension plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of a plan and the method of determination of cost thereof will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the

other Departments. Where pension and retirement plans of non-profit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except as otherwise determined unallowable under this paragraph. Such costs may include excess contributions of ~~previous years~~ *Federal Income* to the extent such contributions are claimed and allowed for <sup>1</sup>tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs.

d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting the current costs otherwise allocable or by obtaining realistic recognition in the actuary's calculation of current costs so that the current costs do, in fact, reflect the discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at

the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest ~~and~~ <sup>by providing and any necessary adjustment to pension plan cost incurred under the contract</sup> provide for the retrospective accounting. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work.

e. The allowability of costs of lump sum purchases of annuities or of <sup>or periodic cash payments</sup> lump sum cash payments made to provide pension benefits for retiring or retired employees other than incurred under approved pension plans will be subject to consideration on an individual case basis.

15-204.27 PLANT PROTECTION EXPENSES. This item includes the cost of wages, uniforms and equipment of personnel engaged in plant protection, supplies, depreciation on plant protection capital assets, and necessary expenses to comply with military security requirements. These costs are allowable.

15-204.28 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract, ~~and may be limited to a period of time as well as to the type and amount of such costs.~~

15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally

are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (1) past pattern of such costs, particularly in the years prior to the award of Government contracts; (2) the impact of Government contracts on the contractor's business; (3) the nature and scope of managerial services expected of the contractor's own organization; and (4) whether or not the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government are unallowable. The costs of legal, accounting and consulting services and related expenses incurred in connection with patent infringement litigation are unallowable unless otherwise provided in the contract."

**15-204.30 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL**

**ASSETS.** Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

**15-204.31 RECONVERSION EXPENSES.** Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract work and include the cost of removal of Government property. Reconversion expenses are not allowable except that the cost of removing Government property and the restoration costs caused by such removal are allowable if specifically provided for in the contract.

15-204.32 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an ~~educational and aptitude~~ <sup>and educational</sup> testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.33 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.) This item includes expenses for (1) use of land, buildings, and equipment or other personal property, and (2) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (1) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

*unless specifically provided for otherwise in the contract*  
 b. Rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) <sup>borne by the lessor</sup> which would have been incurred had the contractor retained legal title to the facilities.

15-204.34 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

✓ "(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.

(A) ~~To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.~~

(B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.

In specially providing for such cost, consideration shall be given to the following factors among others:

- a. Scope, nature and quality of the contractor's independent general research program.
- b. The capability of the contractor in the particular research field.
- c. Benefits which may accrue to the Government.
- d. Comparison of size and cost of contractor's previous years' research programs.
- e. The proportion of the Government business to the contractor's total business."

development (that which is not sponsored by a contract or grant or is ~~not otherwise~~ <sup>arrangement</sup> reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Independent research projects will absorb their appropriate share of the indirect expenses of the department where the research work is performed.

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular (military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."



15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. (1526)

Charges for the use of patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract. (NOTE: This provision, upon reconsideration by the ASPR Committee, was changed from the manner in which it is shown in the minutes of the 6 Dec. 1955 meeting (which are correct) to the form shown above.)

15-204.36 SERVICE AND INSTALLATION EXPENSES. This item includes

viceing the product installation, and training personnel in the use, maintenance and operation of the product. Such costs are allowable.

15-204.37 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (1) law, (2) employer-employee agreements, (3) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (4) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of

\* Army wants consideration given to inserting "consumer"



continuing employment on other work of the contractor is allowable. The amount allowable shall be determined by assigning the total cost of actual mass severance payments to the entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

*Does this conform with latest X111 definition*  
15-204.38 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled, "Government Property".

15-204.39 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for (1) Federal income and excess profits taxes; (2) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.16); (3) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; <sup>insert</sup> and (4) special assessments on land which represent capital improvements.

except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.40 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, technical and professional organizations and such costs are allowable.

b. Subscriptions. This item includes the cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.41 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.42 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items. (See paragraph 15-204.21) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure<sup>\*</sup> in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.43 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable when properly allocated.

\* Army wants insert considered "which provides for equitable results"

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Entertainment expenses are not allowable.

e. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.